LAW AND CONTEMPORARY PROBLEMS

THE CLOSE CORPORATION

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FOREWORD

This symposium is an attempt to explore certain aspects of what is commonly called a close corporation. At the very outset difficulty arises in determining what is meant by this term. For example, the close corporation is usually identified with small business, and undoubtedly most such organizations are small businesses, but there have been and still are many notable exceptions in this country.

Another fact emphasized in attempting to define the close corporation, is that irrespective of the size of the business the stock of the corporation is closely held, that is, it is owned and controlled by a small number of individuals, frequently all members of one family group, and sometimes even by a sole shareholder. Such close ownership of the stock has certain important consequences. Obviously the stock will not be listed on any public exchange. Furthermore, it will not even be handled on over-the-counter markets because transfers or sales of it inevitably will be highly infrequent and usually within the family or other controlling group. To maintain and enforce this ownership usually there will be restrictions on the sale or transfer of the shares, based upon provisions in the certificate of incorporation, the by-laws, or stockholder agreements and options. From this standpoint, not only is stock closely held but also ownership of it is closed to those outside the favored or family group.

Another typical characteristic of the close corporation is that, unlike the publicly owned one, its ownership, control, and management are centralized and unified in one group, namely the shareholders. There usually is no division between the shareholder-owners and the director-managers. Either the stockholders themselves are the directors, or they so closely dominate and control the directors that the latter are in fact little more than their agents. Frequently the shareholders go even further, and besides being directors are also the officers and executives of the company. In any event, either through serving as the directors and officers themselves or through detailed provisions in the charter, by-laws, or stockholder agreements, the shareholders personally manage and control the business directly or else perform these functions through others who in fact simply act as their agents.

This emphasis upon closing the doors of a company to outsiders so far as stock ownership is concerned, and upon the direct, almost day to day management of the business by the shareholders, resembles a partnership rather than the common law concept of a corporation. Yet, at the same time, the shareholders of the close corporation highly prize the corporate privilege of limited liability, and to an almost surprising degree they have achieved this goal, even in the case of the one man corpora-

tion, despite some rather vague limitations on limited liability here not yet fully developed.

When, as often happens, the close corporation is not a one man or one family business but is owned or controlled by two or three individuals or family groups, problems are multiplied and more complicated. Restrictions on the transferability of the shares, the allocation of voting rights, provisions for dividends, assignments of directorships and officerships in the business—all must be carefully planned and worked out beforehand, and thereafter these must be so fixed that they cannot be changed to the detriment of any shareholder without his consent. Failure to give each shareholder such a veto power may well result in the well-known squeeze play or freeze out of one or more minority dissenting shareholders. Since the courts thus far have generally shown little imagination or ingenuity in protecting minority interests in this situation, the burden falls upon shareholders and their counsel to work out adequate protective provisions. Whether the Securities and Exchange Act may offer greater relief than the courts formerly have, is still uncertain.

On the other hand, preservation of the status quo through giving each shareholder a veto power, so that changes may not be made unless all the shareholders consent, may result in a complete deadlock so that action cannot be taken. In the event of such a corporate paralysis dissolution may be as necessary as if a partnership were involved. Yet all too frequently there is no statutory or judicial relief available. Here again, it is the responsibility of counsel to make certain that the corporate documents provide adequate machinery so far as possible for handling such deadlocks through provisions either for arbitration or for dissolution of the corporation.

One of the most striking facts about the close corporation is the extent to which it is the creation of business men and their counsel rather than of the courts or the legislatures. Most corporate legislation is admittedly drafted for the publicly owned company, at least in this country. Unlike Great Britain and Continental Europe, we have made little attempt in our corporate statutes to provide for the problems and the needs of the close corporation. Our tax laws, for example, treat practically all corporations alike, with only a few special provisions attempting to cope with the unique tax problems presented by the close corporation. The courts, by and large, have shown little more creative ability than the legislatures in this area, and only infrequently appear to appreciate the position of the close corporation. The result is that business men and their counsel, whose legitimate needs find expression and satisfaction in the close corporation, are often compelled to operate in clouds of legal doubts and uncertainties and with realities masked by corporate fictions necessitated by awkward legislation and judicial decisions. Consequently, although the close corporation is generally a smaller enterprise than its publicly owned counterpart, its corporate structure and papers as reflected, for example, in charter, by-laws, voting trusts, or stockholder agreements, are frequently far more complex and verbose. Perhaps the time is approaching when our corporate laws should be revised to correspond more closely with the needs and realities of the close corporation.

ROBERT KRAMER.

JUDICIAL TOLERANCE OF THE INCORPORATED PARTNERSHIP

George D. Hornstein*

Variants of the corporate form have vitally affected American life from the very first—even before the moment the Pilgrims set foot on Plymouth Rock. The owner of the lands they had planned to settle was a chartered company, to wit: "The Treasurer and Company of Adventurers and Planters of the City of London for the First Colony in Virginia." The specific voyage was a joint-stock enterprise. And the Mayflower Compact, hastily prepared when the colonists found themselves far north of their expected destination, was designed to provide still another quasi-corporate form without benefit of charter.

Corporation law confirms the eternal legal triangle of statute, common law, and custom; and of these three, as the foregoing illustrations evidence, the most flexible element continues to be custom.[1] Clearly, the law of corporations never was and is not entirely statutory. In a no-man's land unoccupied by the legislature, the "incorporated partnership," for example, is a reality. Its vitality is conclusively demonstrated by flourishing practices, office files, and judicial opinions. Not the legislature, but the judges (who must deal with lawyers) and the lawyers (who must deal with clients) have quickened into life a type of business organization needed to meet the exigencies of the market place.

Changing views as to the nature of the judicial process itself will continue to affect the courts' acceptance of new business forms. Judges have increasingly recognized that law is a social tool to further, not to thwart, the activities of the individual, the tempo of their acknowledgment being accelerated by Cardozo's writings. Such judicial pioneering is actually the essence of our common law system. Judges do not always wait for statute to sanction practices which business has developed to meet new needs and which, the courts find, harm no one. And although the courts have

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[1] Contrast the limited operation (prospective only) of statutes with the operation (both retrospective and prospective) of custom and common law. The present writer subscribes to the views of T. E. Holland, The Elements of Jurisprudence 60 (13th ed. 1924), that to such customs as come up to a certain standard of general reception and usefulness the courts grant retrospective as well as prospective recognition, implying that the custom was law before it received the stamp of judicial authentication. *Contra:* John Austin, Lectures on Jurisprudence §775 (Campbell ed., 1875).

not always been immediately responsive to the customs of the market place, they have not lagged far behind.

The evolutionary character of our common law is especially well illustrated by the incorporated partnership. This adaptability of law to the business environment has been achieved not through some mysterious missing link, but through the art of the counselor, whose skill in the creation of new business forms is as intriguing and socially useful as the work of a naturalist. When from two or more "classic" forms our legal Burbanks evolve a hybrid which is sanctioned by the courts, the product is a new but equally valid species. In law, even unsuccessful efforts help to formulate the outcome. Pioneering must precede the "test" cases which establish the accepted features thereafter to be used with confidence by more conservative members of the profession. For by the very nature of their adaptation to a continously changing business world, business forms are not final but evolutionary.

Upon the classic partnership and the classic corporation modifications have steadily been grafted, until today only those ignorant of actual practices can deny the existence of unincorporated corporations and of incorporated partnerships. Both the partnership and the corporation can be found at least as early as the Middle Ages (and their origins may reach as far back as the partnership of Jacob with Laban, recorded in the Old Testament, or the guild and municipal corporation, so ably depicted by Gross).

In eighteenth-century England at a time when royal and parliamentary strife made incorporation too costly, there developed an unincorporated association without benefit of charter—the joint-stock company. Although technically a partnership (the only business form available without governmental grant), it had none of the classic incidents of a partnership. In fact, every partnership incident was reversed except personal liability, and this vestigial characteristic was limited in so far as contractual obligations were involved. The general incorporation laws of the past century originating in the democratic United States were in one sense, as Maitland said, the graceful capitulation of the state to the unincorporated joint-stock company; these laws were also an inevitable step in an evolutionary process.

The notches cut into the classic forms of partnership and corporation largely obliterated the line of demarcation between them. Not very illuminating then is the definition found in the constitutions of almost half our states that the term "corporation" includes any association "having any of the powers or privileges of corporations not possessed by individuals or partnerships."[2] Yet identification of a business form as partnership or corporation does command more than merely academic interest; it does have pervasive legal consequences.

It may be helpful to restate briefly the well-recognized elements in the older and simpler form, the partnership. Probably its principal characteristic is a negative one—lack of a juristic entity. The affirmative incidents of the partnership are few:

[2] F. J. STIMSON, THE LAW OF THE FEDERAL AND STATE CONSTITUTIONS OF THE UNITED STATES §500 (1908).

The partners as principals own the assets directly; each partner as principal and as agent for his fellow-principals has implied authority to act for all within the scope of the partnership business; and, in the absence of an agreement to the contrary, each partner has a right to take part in the management of the business. By definition, the partnership does not survive the death or withdrawal of a partner.

In the classic partnership these characteristics were reasonable in view of the ensuing legal consequences. Direct ownership results in personal liability; not only the individual's investment but also his personal fortune can be called upon to make good any liabilities incurred within the scope of the partnership business. Since any partner has such unlimited power over the resources of his fellows, there must be complete confidence in all fellow-partners, and new partners cannot be substituted. Also incidental to such extensive power vested in each partner during the life of the partnership is the safeguarding rule that any partner may at any time dissolve the partnership.[3]

Despite the seeming rigidity of these elements in a partnership, one or more may be modified—although if *all* are changed the business form can no longer be called a partnership. Limited liability through use of a "limited partnership" is by statutory enactment available in every state in this country, as well as in England. Power in the common name to acquire and dispose of property real or personal, to sue and be sued is also accorded to partnerships by statutes in many jurisdictions. By agreement, it is conceded, the parties may even provide that the death of a partner shall not result in winding up, but that the survivors shall have the power to continue the business, albeit—theoretically—as a new partnership. A number of these modifications are found in practice with or without benefit of statute. Other changes have been effected under statutes like the Uniform Partnership Act and the Uniform Limited Partnership Act, which modify the common law conception and give to the partnership certain attributes of a juristic entity. Regardless of variations from the classic form, entity attributes are at times also *imposed* by regulatory (or exclusion) statutes, common name statutes, tax laws, bankruptcy practices. Illustrative is the equitable doctrine of "marshaling assets," which gives some effect to the entity while ultimately imposing unlimited personal liability on the general partners.

The partnership incidents, if they may still be so called, contrast sharply with the principal characteristic of the corporation—a juristic entity separate and apart from the members of which it is composed. This feature assures the individual participants freedom from liability beyond the avowed investment in the undertaking; the corporate capital stands in lieu of individual liability of the participants. The entity aspect at times also results in a tax saving, although the pendulum-like swings of the tax law often make the business form which was a tax-saver one year costly taxwise in a subsequent year.

[3] The withdrawing partner, however, will be liable for breach of contract if he lacks legal justification for withdrawal prior to the termination date set in the partnership agreement.

The entity concept of a corporation, however, is no more inviolable than the non-entity concept of a partnership. The courts need not and do not attempt to fit every corporation into a single Procrustean bed. Such action would not be justified by either sound precedent or common sense. The size of the enterprise, the number of participants, the circumstances under which it operates—these characteristics will determine which of several possible concepts shall be employed. The diverse views as to the nature of the business form treat the corporation as: *persona ficta,* a juristic person, but one lacking elements which an anthropomorphic metaphor is unable to confer upon it;[4] *a reality,* almost like a natural person;[5] *an enterprise entity* which takes its being from the reality of the underlying enterprise;[6] or *a symbol* for an aggregate of men and women and their jural relations.[7]

Confusion must result when the name "corporation" is applied indiscriminately to a legal form which may have a life shorter than that of the butterfly (of record are corporations formed in a morning for a limited purpose and dissolved the same afternoon after that object had been achieved), as well as to a legal form whose life may be expected to continue as long as our economic system survives; to an enterprise with over a million shareholders as well as to one with but a single shareholder. Is the sole shareholder, moreover, the sovereign government itself, or a legitimate businessman who intends to operate in the corporate form to limit his liability, or a fly-by-night promoter who is cloaking his operations in corporate form to avoid accountability for fraud, *i.e.,* conduct which would be fraudulent were it not in corporate form?[8] The varied Protean-like forms which the term "corporation" conceals illustrate the consequences which ensue when the metaphor obscures reality, when words intended as an aid to understanding become a substitute for it, when connotations start a chain reaction of new meanings. Called by Littleton and Coke[9] "a body politike" (= framed by policy of the law); said by Marshall[10] to be an "artificial being, invisible, intangible, and existing only in contemplation of law"; defined thereafter by Angell and Ames[11] as "an intellectual body" (= perceptible only to the intellect); the ultimate refinement is to be seen in one statute that "corporations are intellectual beings, different and distinct from all the persons who

[4] Case of Sutton's Hospital, 10 Co. 23a, 32b, 77 Eng. Rep. 960, 973 (K. B. 1612). For an excellent analysis of both the "fiction" and "realist" theories, see FREUND, LEGAL NATURE OF A CORPORATION (1896).

[5] Salomon v. Saloman & Co., Ltd., [1897] A. C. 22, 33-34. This doctrine, formulated by Gierke in Germany, was sponsored by Pollock in England.

[6] Berle, *Enterprise Entity Theory,* 47 COL. L. REV. 343 (1947).

[7] CARDOZO, THE GROWTH OF THE LAW 29-30 (1924); see Farmers' Loan & Trust Co. v. Pierson, 130 Misc. 110, 119, 222 N. Y. S. 532, 543 (Sup. Ct. 1927). Professors Hohfeld, Machen, and Morawetz all favored this concept.

[8] Old Dominion Copper Mining & Smelting Co. v. Lewisohn, 210 U. S. 206 (1908). *Cf.* Old Dominion Copper Mining & Smelting Co. v. Bigelow, 188 Mass. 315, 74 N. E. 653 (1905) (on demurrer), 203 Mass. 159, 89 N. E. 193 (1909) (on merits), *aff'd,* 225 U. S. 11 (1912) (holding the earlier decision in 210 U. S. 206 not res judicata as to bind the Massachusetts court).

[9] Co. Litt. * 250a.

[10] Trustees of Dartmouth College v. Woodward, 4 Wheat. 518, 636 (U. S. 1819).

[11] J. K. ANGELL AND SAMUEL AMES, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS AGGREGATE 21 (1832).

compose them."[12] Although centuries ago Coke, and still earlier, in 1245, Pope Innocent IV (himself a lawyer) had ruled that the corporation (*corpus* = body) does not have a soul and cannot be excommunicated, the stage is almost set for revival of the question whether a corporation does have a soul. One modern corporation has actually described itself as "the corporation with a soul."

It is not the object of this writer to enter the lists on behalf of any one of the foregoing concepts to the exclusion of all others. Each of the theories is useful for certain purposes. No theory should be employed, however, which will defeat the public convenience or protect fraud or iniquity or inequity. Even the most ardent advocates of "the fiction theory" would themselves pierce the corporate veil to win their mistress, Justice.[13]

Changing views as to the nature or incidents of a corporation have naturally produced varied legal consequences. Unchanged is the feature that a corporation must have a local habitation and a name in which it can acquire and dispose of property real or personal, enter into other legal relations, sue and be sued. But all other aspects of legal personality have been under pressure. The separate juristic entity has often been ignored by the Supreme Court of the United States, which looked through the corporation to the underlying owners and applied constitutional safeguards to protect *their* rights.[14] Where a corporation had been inadequately capitalized, its controlling shareholder has found—although on extremely rare occasions—that limited liability is denied him;[15] more frequently the entity is disregarded to the extent of subordinating to the claims of outside creditors a claim of the stockholder as a creditor for money allegedly loaned (not contributed as capital) to the enterprise.[16] For tax purposes also the corporate entity has on occasion been disregarded: at one time to tax the shareholders as if they were partners in the business;[17] and, conversely, to prevent unjustified taxation, as when it is recognized that common shareholders receiving a stock dividend have really received nothing of value in addition to what they possessed before.[18]

Although the corporation does have some attractive features, especially that of limited liability, the incorporators join together as in a marriage of convenience. For despite the over-all appeal, enterprisers in a small venture dislike at least three

[12] La. Civ. Code §435 (Dart, 1945).

[13] Wormser, *Piercing the Veil of Corporate Entity*, 12 Col. L. Rev. 496 (1912).

[14] Henderson, Position of Foreign Corporations in American Constitutional Law 174, 186 (1918).

[15] Luckenbach S. S. Co., Inc. v. W. R. Grace & Co., Inc., 267 Fed. 676, 681 (4th Cir. 1920); Oriental Investment Co. v. Barclay, 25 Tex. Civ. App. 543, 559, 64 S. W. 80, 88 (1901); see E. R. Latty, Subsidiaries and Affiliated Companies (1936).

[16] Taylor v. Standard Gas & Electric Co., 306 U. S. 307 (1939) (claim subordinated); Pepper v. Litton, 308 U. S. 295 (1939) (claim disallowed).

[17] Section 117 of an Act to provide Internal Revenue, etc., 13 Stat. 223, 282 (1864), directed that "the gains and profits of all companies, whether incorporated or partnership . . . shall be included in estimating the annual gains, profits or income of any person entitled to the same, whether divided or otherwise." Excepted from this provision and accorded different tax treatment were corporations in specified types of business, *e.g.*, banks, insurance companies, railroads. This Civil War legislation was interpreted and applied in Collector v. Hubbard, 12 Wall. 1 (U. S. 1870).

[18] Eisner v. Macomber, 252 U. S. 189 (1920).

attributes of the corporate form: centralized management in a board of directors; free transferability of ownership shares; continuity of organizational life despite the death or withdrawal of a participant. Knowing that these are the usual subjects of controversy, a minority shareholder-to-be is concerned in the first instance about the power of abuse by the directors or majority shareholders. He realizes also that he can get out of the business only by sale of his shares or by the power to compel termination of the venture. By a shareholders' agreement the participants seek to modify or dispense with the unwanted attributes, to anticipate potential sources of dispute on these and other subjects before they arise, and to make provision for their amicable settlement.

What is or should be the public policy with respect to such shareholders' agreements?

It is true that one may raise the important question of how public policy is determined. In one sense, of course, public policy is a matter of adding up individual opinions; for "what one man or one Judge . . . might think against public policy, another might think altogether excellent public policy."[19] And however firmly established by judicial opinion may be a conclusion as to public policy, it gives way when the legislature by statute announces a contrary rule. Legislation, however, must be interpreted by the courts. Those which, for example, emphasize the statutory declarations that "the business of a corporation shall be managed by its board of directors,"[20] must minimize another statutory provision that the certificate of incorporation "may contain any provision for the regulation of its business and the conduct of its affairs, and any limitation upon its powers, or upon the rights of its stockholders or upon the power of its directors and members, which does not exempt them from the performance of any obligation or duty imposed by law."[21] In at least one state (Ohio) the theory of the general corporation laws is very clearly that a corporation is a contract, precisely as is a partnership.

It is the court which ultimately must determine whether the legislative "policy" can be so-called only in a Pickwickian sense, whether the enactment into "law" of the wishes of a persuasive group concerned with the problems of the large corporation necessitates the frustration of carefully considered agreements by participants in a small venture, also labeled a corporation. Here the court must exercise functions more nearly legislative than judicial. Sometimes judicial interpretation of legislative policy is reversed by the legislature, which then leaves no doubt as to its attitude; witness: New York's recent law validating shareholders' agreements.[22] In support of such voluntary agreements to avoid dissension, it may be noted further that the law favors the settlement of disputes; that parties may stipulate in an agreement an exclusive form of remedy which the courts will enforce; that parties by

[19] Besant v. Wood, 12 Ch. Div. 605, 620 (1879) (per Jessel, M. R.).

[20] N. Y. GEN. CORP. LAW §27. A comparable provision appears in the statutes of more than three-quarters of the states.

[21] N. Y. GEN. CORP. LAW §13(2). Other states have a provision equally broad, *e.g.*, Delaware, Massachusetts.

[22] N. Y. STOCK CORP. LAW §9.

stipulation may even waive the right to appeal. It is difficult, therefore, to find any logical reason why legally competent individuals should not be able to adapt a statutory business form to the structure they want, so long as they do not endanger other shareholders, creditors, or the public, or violate an unequivocal mandatory provision of the statutory law.

We thus come to what is interchangeably called a "chartered partnership"[23] or an "incorporated partnership."[24] This classification connotes more than the term "close corporation," which has been defined as "a corporation in which the stock is held in few hands, or in few families, and wherein it is not at all, or only rarely, dealt in by buying or selling."[25] The broader term includes also the very important problems of control.

A few—amazingly few —opinions have touched upon the possibility of an outright "incorporated partnership" with stock certificates being issued to "A and B, as partners," instead of to the parties severally. A handful of these opinions have held or suggested that the parties would then be partners *inter se* while still enjoying the protection of limited liability.[26] The non-use of this device strongly indicates a professional sense that the practice will not win general judicial sanction.

It is unfortunate but clear that where the shares of stock have been issued to the individual shareholders severally, most courts would presently hold invalid a frank agreement that the corporation shall be operated as a partnership.[27] Just how far then can participants go to achieve their objective? What do the courts strike down?

I

CENTRALIZED MANAGEMENT

Courts during the past century have endeavored to maintain the "norm" of centralized management. Their alleged justification was that directors derive their power from the state, not from the shareholders. Behind this bald statement stood the "concession" or "restrictive" theory of corporations which emphasized the high nature of the act of sovereignty by which the corporate franchise is conceded and the extraordinary character of the privileges with which member of a corporation are endowed.

The concession theory, however, has been riddled by reality. What was once a

[23] Bissell v. Michigan Southern & Northern Indiana R.R., 22 N. Y. 258, 270 (1860).

[24] Cuppy v. Ward, 187 App. Div. 625, 629, 639, 176 N. Y. S. 233, 236, 243 (1st Dep't 1919), *aff'd*, 227 N. Y. 603, 125 N. E. 915 (1919).

[25] Brooks v. Willcuts, 78 F. 2d 270, 273 (8th Cir. 1935). *N.B.* What we term a "close corporation" the British call a "private company." Their term "close corporation" is confined to what we call a "co-opt."

[26] Smith v. San Francisco & N. P. Ry., 115 Cal. 584, 601, 47 P. 582, 588 (1897); Arnold v. Maxwell, 223 Mass. 47, 111 N. E. 687 (1916); Seitz v. Michel, 148 Minn. 80, 84, 181 N. W. 102, 104 (1921); King v. Barnes, 109 N. Y. 267, 288, 16 N. E. 332, 338 (1888); *cf.* La Varre v. Hall, 42 F. 2d 65 (5th Cir. 1930).

[27] Jackson v. Hooper, 76 N. J. Eq. 592, 599, 75 Atl. 568, 571 (Ct. Err. & App. 1910). *Contra:* Wabash Ry. v. American Refrigerator Transit Co., 7 F. 2d 335 (8th Cir. 1925), *cert. denied*, 270 U. S. 643 (1926); Flanagan v. Flanagan, 73 N. Y. S. 2d 267 (Sup. Ct. 1947), *modified*, 273 App. Div. 918, 77 N. Y. S. 2d 682 (2d Dep't 1948), *aff'd*, 298 N. Y. 787, 83 N. E. 2d 473 (1949).

royal grant to a few favored friends has become through democratic incorporation laws the statutory right of all and sundry. Moreover, charter-mongering—eager competition between the states for the business of chartering corporations—has completely undermined the high character of the act of sovereignty. The extraordinary privileges have become ordinary.

Valid throughout the country (except in Louisiana) are one-man corporations, where there can be no denial that the corporation is actually managed by the "one man" shareholder, not by the nominal board of directors.[28] If two or more shareholders are involved, the public policy so-called invariably permits nullification or modification of corporate incidents when effected through the use of accepted techniques embodied in the articles of incorporation. For example, the principle of majority control in the election of directors may be nullified by giving voting shares to favored participants and non-voting shares to others, or by use of multiple voting shares similarly allocated, or by use of classified shares. Half the states, moreover, expressly authorize voting trusts which bind the owner more effectively than if he had retained the shares under a commitment as to how he would vote. Acceptance of limitations, if a magic *form* be observed, does not bespeak an enlightened public policy. It confirms rather the belief of many laymen that law is a trap for the unwary.

The theory that the corporation conducts its normal operations only through directors is based upon the unfounded assumption that there is a traditional division of corporate functions. Unfortunately for this theory, some of to-day's so-called norms are the precise reverse of earlier practices, and others at this time are not uniform in all states. Shareholders in the eighteenth century voted directly on certain matters of corporate policy (such as the declaration of dividends) and by vote themselves appointed the executive officers, the latter practice surviving to this day in a dozen states. In England shareholders are regarded as the source of the directors' power; for a score of years England, in fact, did not require a board of directors at all in a "private company," their form of organization which best approximates our close corporation. One of our own states, Iowa, similarly does not require a board of directors. Is it not pointless then to insist upon prerogatives which can at any time be nullified by the shareholders' exercise of their power (unless waived in the articles) to increase the number of directors and to name as new directors men who will be responsive to the shareholders' wishes?

[28] The parallel problems of partnership and corporation are again illustrated when one considers the number of persons who may use one form or the other. The Joint-Stock Companies Act, 1856, 19 & 20 VICT. c. 47—in a single Act—provided that more than 20 persons could not as a partnership carry on business for profit (§4), and conversely that if the number of shareholders in a corporation fell below 7, the participants could be deprived of the right to carry on business as a company (§67). Similar minimal numbers for a corporation were prescribed in a number of our states. Once a minimum number of shareholders for a corporation was abandoned, the next logical stage was the one-man corporation. Today three states (Iowa, Michigan, Wisconsin) by statute expressly authorize one-man incorporation at the outset, and thereby dispense with the "legal form" prescribed in other states, where three "dummy" or "accommodation" incorporators start the corporation functioning and then assign their nominal shares to the real party in interest.

Another justification advanced was that "the parties cannot be partners as between themselves and a corporation as to the rest of the world." This is mere dogmatic statement, not explanation, for courts which take the opposite position (enforcement of shareholders' agreements) are equally decisive in "explaining" that the parties are "virtually partners." A multitude of situations where, even in the absence of any shareholders' agreement, courts have for certain purposes treated shareholders as partners demonstrate also that there is no inherent objection to this attitude. The famous holding in *Eisner v. Macomber* that a stock dividend is not taxable income to the shareholder-recipients is based upon the power *and duty* of the court to look through the corporate form.[29]

The absence of any definitive public policy is apparent in opinions which consider the circumstances under which an agreement was signed, how long it had been in operation without attack upon its validity, whether the person now questioning and endeavoring to repudiate it is in effect "welshing," whether estoppel or a change in position requires its enforcement.

In contrast to early decisions which adjudged void even the simplest shareholders' agreement seeking to modify management by the board of directors, the current case law discloses a tendency to permit some "impingement" upon the principle of centralized management, with the likelihood of judicial sanction increased if all shareholders have signed the agreement. Several modifications are usually attempted: commitment in advance as to the individuals to be chosen directors; change in the bases whereby directors act; control of directors' discretion by having the agreement directly name the officers or fix corporate policies ordinarily determined by directors; superseding of the directors by naming a general manager with powers usually exercised by the board of directors; restrictions on majority rule; grant to the minority of exceptional power to compel dissolution or to prevent it.

The following presentation is a compressed summary of judicial attitude with respect to these attempted modifications. Because of space limitations for this article, all details, qualifications, and exceptions are omitted.[30]

Most courts in the absence of statute will hold invalid a shareholders' agreement (whether in the articles, by-laws, or a separate agreement) requiring unanimity for the election of directors, although an agreement not to vote at all may be valid. Similarly void is an agreement requiring any percentage vote higher than that set by statute, although the result again can be validly achieved—by vote-weighting the shares. Recent legislation in a few states now does permit requirement of a super-statutory majority, even unanimity, if the requirement be set forth in the articles of incorporation.

[29] See note 18, *supra*.

[30] Fuller details will appear in the author's forthcoming treatise on Corporation Law and Practice. See also Hornstein, *Stockholders' Agreement in the Closely-Held Corporation*, 59 YALE L. J. 1040 (1950); Delaney, *The Corporate Director: Can His Hands Be Tied in Advance*, 50 COL. L. REV. 52 (1950); O'Neal, *Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting*, 65 HARV. L. REV. 773 (1952).

Although in the absence of statute a requirement of unanimity for *all* action is not generally sanctioned, valid and enforceable everywhere would be an agreement signed by all shareholders to vote their shares as a unit to assure the election as directors of specified persons (usually themselves). In most states the agreement would be enforceable even if some shareholders had not signed.

It is sometimes said that in this country (unlike England) even unanimous vote of the shareholders cannot force a board of directors to act contrary to its judgment and that refusal by the directors would not be cause for their removal. Most scholars discussing what the law *should be* advocate the contrary position—that a unanimous vote of the shareholders should control or overrule directors. The "law" may be said to be uncertain.

In lieu of attempts to force directors to comply with the unanimous directions of shareholders, some efforts have been made, in the articles, by-laws, or shareholders' agreements, to vary the bases on which directors act. Efforts to require a quorum higher than that prescribed by statute for a directors' meeting have been unsuccessful. Similarly unsuccessful have been provisions that the directors act only by unanimous vote; but occasional cases do sustain the requirement of a voting percentage higher than set by statute provided the percentage be less than unanimity. The shareholders' agreements for control of directors which are most commonly enforced deal with specific items of action ordinarily within the province of the directors, especially as to the appointment and removal of officers and the determination of dividend policy.

In a dozen states, as in England, the statute permits or prescribes that some or all officers be directly elected by the shareholders. In such jurisdictions a shareholders' agreement specifying who shall hold these offices is of course valid, just as is an agreement earlier discussed for election of directors. In most states, however, the corporation statutes require that officers be designated by the directors. In such states, courts have generally sustained composite agreements of *all* shareholders to elect certain of their number as directors, and then as directors to appoint designated persons (usually the same persons) to particular offices at stated salaries. A few courts have enforced such an agreement even though some of the shareholders were not signatories. Officers ordinarily may be removed not only for cause, but without cause—unless the agreement provides to the contrary. To protect further officers who are minority shareholders, a provision is commonly included that their employment can be terminated only by vote of a specified number of directors.

Although the declaration of dividends is now, as a general principle, within the discretion of the directors, attempts to control the dividend policy have been fairly successful. Probably no court would deny the validity of an agreement which curtails directoral discretion by forbidding the declaration of dividends under specified circumstances. A decision to the contrary would seriously affect billions of dollars of bond indentures already in existence which rely on just that limitation. The converse agreement, providing for compulsory dividends, has also been held

valid; and, where sufficiently detailed and explicit, has been specifically enforced.

Fear of an independent board of directors and of a majority vote of shareholders which might change the make-up of the board occasionally produces a provision attempting to by-pass the board of directors and strip it of its directoral powers by the appointment of a general manager completely superseding the board. The authorities divide on the validity of such a provision. Factors which influence a court's decision are the length of period for such control and ability to find any of the board's official duties left undelegated. Sharply to be contrasted with the shareholders' displacement of the board by the appointment of a general manager (especially one who is a non-director, an "outsider") is the delegation of the board's powers to an executive committee of one or more of its own members. Such an executive committee is everywhere sanctioned.

Efforts to require unanimity of shareholders have not been confined to the election of directors. Agreements have sought also to make unanimity necessary on other phases of shareholder participation in management, for example, the amendment of by-laws (except where this power is vested in the directors) or the adoption of resolutions at shareholders' meetings. The courts usually uphold a requirement of unanimity for changes in the by-laws or for the adoption of specific shareholders' resolutions, but not for *all* shareholders' resolutions.

II

TRANSFERABILITY OF SHARES

In marked contrast to judicial resistance to inroads on centralization of management is the court's willingness to permit modification of the second of the so-called norms—"free transferability of ownership shares." The problems anticipated by the parties with respect to transferability are identical with those in a partnership and the proposed solutions, as is to be expected, are parallel. Here we find that the courts have long been sustaining reasonable restraints, much as they would in an ordinary partnership agreement. In fact, the rule in this country[31] appears to be that shares are freely transferable *unless* a reasonable restriction on transfer is affirmatively stated. Into the standard of reasonableness three elements enter: the objective, actual or believed; the degree of restraint (or the duration of an absolute restraint) proposed to attain that objective; the source of the restriction —*where* it appears or *when* the agreement containing it was first made.

A. Objective

The objective of a restraint on transfer is material. The state wants corporate enterprises to be successful. Hence the desire to choose one's associates or to restrict shareholdings to current employees (to protect the corporation from disgruntled former employees) has usually been accepted as a legitimate purpose

[31] Contrast limitations on transferability imposed by English legislation in a "private" corporation, and by Michigan and Pennsylvania on "partnership associations." The latter bar transfer unless the transferee be acceptable; if he be unacceptable, his interest must be bought out.

and sufficient justification for a reasonable degree of restraint, although supplemental reasons are sometimes assigned. Most courts will go further and sanction a supplemental requirement that the shares offered be made available pro rata to the remaining shareholders, thus maintaining the status quo in control; in a state where the law is doubtful, the same result can be achieved by requiring resale to the corporation itself (if the state is one where the corporation may purchase its own shares). Most valid provisions are actually not restraints at all but simply the first step in a sale, and their objective is to assure a reasonable price by setting up the basis before disputes set in. Improvidence in the contract does not concern the court.

B. Degree of Restraint

The most important element affecting the validity of a transfer restraint is naturally the degree of restraint or the period of duration for an absolute restraint. One must bear in mind, however, that the reputed norm of free transferability causes any restriction to be strictly construed—in favor of transferability. The most common restriction is a "first option" (or "first right of refusal," as it is sometimes described)—prohibition against sale of the shares to an outsider unless first offered to the corporation or to the remaining shareholders; this first option is sometimes extended to the corporation's directors or officers. Analogous to the first option is the common requirement that a deceased shareholder's estate or a shareholder who ceases to be employed by the corporation *must* within a specified period offer to sell his shares to the corporation or to the remaining shareholders. A first option is uniformly enforced unless circumscribed by legal limitations other than the doctrine of free transferability. Details for arriving at the purchase price and provisions for its payment, so important to the parties, raise no policy problem for a court.

Other limitations which might result in a permanent restriction, such as a requirement that the directors or other shareholders approve before shares can be transferred, have caused courts to divide sharply.[32] Restrictions barring transfers to competitors have encountered considerable judicial opposition and are therefore infrequently used. Surprisingly, similar uncertainty prevails with respect to restrictions on sales to aliens.[33]

No time limit is specified ordinarily for the first option to arise, as contrasted with the time within which it must thereafter be exercised, the latter period commonly being set at 30 days. No time limit is necessary because a "sale" agreement whose restrictions simply impose conditions is not an absolute restraint, although the conditions do make the shares less attractive and lower the value on a sale. In almost all cases where the courts have voided a restraint in the articles or one appearing elsewhere of which notice was adequate, the basis has been that the restraint was absolute by its terms or in effect. The objection is ultimately (not

[32] Uniformly, however, courts sanction a provision in corporate-owned co-operative apartment houses that no new shareholder be there recognized without approval of the board of directors.

[33] State statutes may bar shareholding by an alien or may limit land-ownership by the corporation if more than a specified percentage of its shares is held by aliens.

always soundly) based on the Rule against Perpetuities or suspension of the power of alienation or some analogous principle not clearly articulated.

Absolute restraints for a fixed period of time, usually fairly short, have been adjudged valid by a number of courts, with or without express consideration of the problem. In the analogous voting trusts, a maximum, usually ten years, is set by statute. In the absence of statute, draftsmen obviated any question of whether the Rule against Perpetuities applied by limiting the voting trust within the period permitted by that Rule. On the other hand, a recent Delaware decision passing on the validity of a transfer restraint (in a voting trust agreement), set forth its attitude in unmistakable terms: "No agreement would ever constitute a restraint on alienation if we were to give weight to the fact that all parties thereto by unanimous action could always obviate the restraining provision. Yes, we have here a very effective restraint on alienation. . . . Any restraint is invalid unless accompanied by circumstances which would justify a reasonable restraint."[34] An equally realistic decision was rendered in Alabama passing on a by-law which barred a shareholder from selling his shares except to other shareholders at book value; the court pointed out that there was no reciprocal obligation on the part of the other shareholders to buy, so that as a practical matter the restraint on alienation was unreasonable.[35]

C. Source of Restriction

The source of a restriction—*when* the agreement is first made or *where* it appears —is sometimes determinative of its validity. It is not always clear, however, which most influences the court—the timing or the document's standing in the hierarchy of constitutive corporate documents.

Courts tend to sustain a transfer restraint imposed when the corporation is first organized. The explanation sometimes given is that the agreement is part of the conditions under which the corporation was formed and the shares issued—that the privilege of free transferability, for example, is removed before the shares come into existence. But in most instances the nature of the document seems to be determinative, a type of degree of restraint valid in articles of incorporation being ruled invalid in a by-law or mere agreement. Since the provision becomes valid if the articles are amended to include it, not very persuasive is the theory that timing is the important element.

In almost all states unlimited latitude (short of an absolute prohibition on transfer) is permitted for restraints in the articles of incorporation. By-law restraints are not so uniformly sanctioned. Courts refusing enforcement justify their position by explaining that by-laws adoptable by less than unanimous vote cannot be sanctioned as a vehicle for cutting down rights of free transfer usually expected; they argue moreover, that a corporation (whether acting by shareholders or directors) lacks

[34] Tracey v. Franklin, 61 A. 2d 780, 784-785 (Del. Ch. 1948), *aff'd*, 67 A. 2d 56 (Del. Sup. Ct. 1949).

[35] Security Life & Acc. Co. v. Carlovitz, 251 Ala. 508, 38 So. 2d 274 (1949).

authority to curtail "private rights" through by-laws which normally regulate corporate property, not the individual property of the shareholders. Where a restraint is enforced which appears only in a by-law (and as a by-law is invalid), the court usually explains that it is being enforced as an agreement—because agreed to by *all* the parties at the time the corporation was first organized, or because notation thereof appeared on the stock certificate and therefore was impliedly consented to by the purchaser. Although the articles of incorporation are a matter of public record, the fact that they are not read by investors is recognized by a provision in the Uniform Stock Transfer Act that a restriction cannot be enforced unless noted on the stock certificate.[36]

III

PERMANENCE

Continuity of the organization's life despite the withdrawal or death of a participant is the third of the corporate incidents which concerns shareholders or potential shareholders in a corporation. Within recent years legal draftsmen have begun to make provision for compulsory dissolution upon the happening of certain contingencies. Here, the author anticipates, case law will match the liberality sanctioning reasonable restraints on transferability, unlike the conservatism sometimes encountered in attempts to eliminate centralized management. Provisions relating to dissolution may be designed to give a minority which feels oppressed the right to compel dissolution. Or they may have as their purpose the prevention of dissolution where such action would prejudice either the majority or a minority.

Current trends in corporation law recognize the power in a court of equity to decree dissolution in a proper case, even at the suit of a minority shareholder. Can an agreement expand this power of a minority to compel dissolution? Would the courts, for example, enforce a unanimous agreement by the shareholders that the corporation shall be dissolved when one of the parties dies, or enters a competing business, or if dividends have not been declared after the lapse of a specified number of years, or on some other equally foreseeable contingency? The law as to the validity of such a provision is unsettled, condemnation being based on the semantic objection that it attempts to make a "partnership" of a corporation. Can a unanimous agreement expand the power of a 50 per cent or majority holder to dissolve a corporation, *e.g.*, by negativing in advance any necessity for good faith in exercising his power to dissolve under a statute? We may note here the analogy that when a partnership agreement provides that a majority in interest of the parties may force a minority partner to withdraw, the good faith or motive of the majority may not be questioned.

The converse provision, *i.e.*, to limit dissolution, poses an even more difficult question. The majority or some higher percentage of shareholders usually is

[36] Although most states adopted the Uniform Stock Transfer Act verbatim, the section referred to in the text is missing in Kansas and North Dakota, and appears materially changed in California laws. 9 U. L. A. §15 (Supp. 1951).

granted by statute an apparently absolute right to dissolve; in addition, as above noted, current trends recognize the power in equity to decree dissolution in a proper case, at the suit of majority or minority. The authorities are fairly uniform that the parties by agreement in advance may limit their statutory right to cause dissolution. An agreement can probably require, for example, that parties seeking dissolution show a real difference of opinion as to management or that dissolution would actually benefit all shareholders. Any attempt, however, to limit the court's equitable power invites judicial condemnation. Significantly, an amendment to the New York Stock Corporation Law permitting a requirement of unanimity for all shareholders' action and all directors' actions, specifically states that nothing in the section "shall be construed to limit the power of a court of equity to decree a dissolution in a proper case."[37]

The subject of dissolution cannot be easily passed over, as it once was, by suggesting that limiting the period of incorporation to a fixed (possibly short) term of years would permit periodic reconsideration of whether its life should be extended. That suggestion had some weight at a time when renewal of a charter required unanimous consent. To-day, however, many states make possible extension of the period of corporate existence, either for an additional term of years or in perpetuity. This may usually be done by a statutory majority, *i.e.*, it may be done over the objection of dissentients. No longer is a limited period for corporate life any assurance to individual shareholders that the corporation will be liquidated at the expiration of that period.[38] Nor is there presently available to him relief by way of an offsetting statutory right of appraisal—a form of remedy which has been made available to shareholders dissenting from many other types of majority action.[39]

CONCLUSION

America is to-day the largest industrial nation committed to a free enterprise economic system. Our economy has been encouraged in large part by the doctrine of limited liability—the opportunity to confine one's risk to his investment. If limited liability be available only to "big business," however, relatively small business is doubly threatened. To the layman and to the lawyer unawed by precedent, the insistence upon unnecessary conditions as the price of limited liability for the small businessman seems unfairly discriminatory, and worse. It is utterly inconsistent with the government's desperate efforts to strengthen the free enterprise system and to alleviate the problems of the small business corporation even at the cost of making tax concessions to it.

A century ago a wise judge pointed out that any corporation is in effect a partnership without personal liability.[40] The legal craftsmen and later judges have helped confirm his analysis.

[37] N. Y. STOCK CORP. LAW §9.

[38] Garzo v. Maid of the Mist Steamboat Co., 303 N. Y. 516, 104 N. E. 2d 882 (1952).

[39] N. Y. LAW REV. COMM'N, LEGIS. DOC. No. 65 (I) 390-394 (1943).

[40] Spencer, C. J., in Slee v. Bloom, 19 Johns. 456, 473 (N. Y. 1822).

It may be expected that with the passage of time more courts will rely less on rigid corporate "norms" and substitute instead frank examination of a questioned agreement to ascertain its purpose and effect, whether its making carries with it any potential danger to the public, to creditors, or to other shareholders. The trend is clear.

GIVING SHAREHOLDERS POWER TO VETO CORPORATE DECISIONS: USE OF SPECIAL CHARTER AND BY-LAW PROVISIONS*

F. Hodge O'Neal†

This paper examines the planning and drafting problems involved in the use of special charter and by-law provisions to give minority shareholders power to veto corporate decisions. It considers not so much the phrasing of veto provisions for use in the charter and by-laws as the approaches that may be taken to confer a veto. Statutory materials and corporate concepts which determine the validity and efficacy of veto provisions are discussed in considerable detail. Attention is also given to precautions that increase the usefulness of veto provisions or lessen their vulnerability to circumvention or attack.

I

Failure of Law and Lawyers to Meet Business Need for Veto

Businessmen forming a closely held corporation not uncommonly consider themselves partners as to each other; they incorporate to obtain limited liability or other corporate advantage. Those who are to have minority interests in the business therefore not infrequently seek protection against the broad powers normally vested in shareholders and directors to determine corporate policy and to make decisions by simple majority vote.[1] In short, they want a power to veto some or all corporate policies and decisions.

The business situation may call only for a power to veto a particular change in

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[1] Participants in a closely held corporation often seek to escape other normal attributes of the corporate form of business and to gain for their enterprises advantageous partnership attributes. Typically, they want to restrict the transferability of shares in the corporation and to establish options for the purchase of shares of deceased holders. See Note, 2 A. L. R. 2d 745 (1948). They commonly seek to impose sharp restrictions on the normal authority of the board of directors. They sometimes want profits or voting power allocated on a basis divergent from shareholding. See Nickolopoulos v. Sarantis, 102 N. J. Eq. 585, 141 Atl. 792 (Ct. Err. & App. 1928). The satisfaction of these desires taxes the ingenuity of lawyers charged with drafting charters, by-laws, and shareholders' agreements for closely held enterprises. Further, the giving of veto powers to shareholders increases the chance of deadlocks and creates a need for a speedy means (perhaps arbitration) of resolving differences, or for a satisfactory method of dissolving the enterprise when corporate paralysis ensues. See Israels, *The Sacred Cow of Corporate Existence: Problems of Deadlock and Dissolution*, 19 U. of Chi. L. Rev. 778 (1952). The authorities considered in this paper and the approaches suggested here for tailoring the corporate form to the shareholders' desire for a veto will often be found pertinent to the other problems that lawyers encounter in drafting corporate instruments.

the corporate structure. For instance, a participant may be willing to invest in a particular kind of business and in nothing else, and thus he may want to be able to veto charter amendments that would authorize the corporation to engage in other activities. More frequently, business considerations call for a veto over policy decisions, or even over day-to-day decisions on the operation of the enterprise.[2] In some instances, participants insist on power to veto substantially all corporate acts.[3]

Participants in a closely held enterprise usually expect to become directors and to occupy executive positions. Therefore, they are likely to be especially interested in being able to prevent removal of directors and officers, modification of their authority or duties, and change in their salaries or perhaps in the ratio between salaries. Each shareholder normally wants to be in a position at least to avert salary reduction in the office which he is to hold. On the other hand, a shareholder who puts up the lion's share of the money for an enterprise may well want a veto over salary increases, dividend payments, the purchase or retirement of the corporation's stock, the creation of indebtedness,[4] and perhaps the issuance of preferred stock.

The difficulty of disposing of holdings in a closely held corporation augments the desire of minority shareholders for a veto over corporate decisions. Restrictions are often placed on the transferability of shares in a closely held corporation;[5] and, even in the absence of restrictions, a minority interest in a closely held corporation does not have a ready market. The fact that minority shareholders cannot readily withdraw their funds from the venture whenever they become dissatisfied with its operation naturally strengthens their desire for a power to veto corporate decisions.

The business considerations giving rise to the desire for a veto usually have not been reflected in the incorporation papers and other instruments that lawyers have prepared for closely held enterprises. The explanation of this failure to meet business needs lies in part in an absence of legislative recognition of the special management problems of closely held corporations and in part in an inability of lawyers to break away from traditional thinking on corporate management patterns. Statutes and judicial decisions, with but few exceptions, lay down the same rules for all corporations and make no distinction between closely held and widely held enterprises.[6] At the same time, many lawyers have failed to take advantage even of the limited flexibility permitted by existing laws. As they say, they are opposed to giving share-

[2] See Bator v. United Sausage Co., 138 Conn. 18, 81 A. 2d 442, 443 (1951).

[3] See McQuade v. Stoneham, 263 N. Y. 323, 189 N. E. 234 (1934) (the amount of capital, the by-laws, the number of shares, salaries, and business policies were to be changed only by unanimous consent); Kaplan v. Block, 183 Va. 327, 31 S. E. 2d 893 (1944) (unanimity required for "any matter concerning the administration and management of the affairs of the corporation").

[4] See Hart v. Bell, 222 Minn. 69, 23 N. W. 2d 375 (1946) (agreement among shareholders that dividends would not be declared until loans by a shareholder to the corporation had been paid.)

[5] Participants in a closely held corporation usually want to be able to prevent the admission into the enterprise of new members they consider undesirable. That power can be effectively granted by restrictions on the transfer of stock. See O'Neal, *Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting*, 65 HARV. L. REV. 773 (1952). Lawyers throughout the country are familiar with these restrictions, and they are widely used.

[6] Weiner, *Legislative Recognition of the Close Corporations*, 27 MICH. L. REV. 273 (1929); Winer, *Proposing a New York "Close Corporation Law,"* 28 CORNELL L. Q. (1943).

holders a power to veto corporate decisions or to "tampering in any way" with the customary powers of shareholders and directors to rule by majority vote. The result has been that the management pattern prevalent in widely held corporations has been fastened upon closely held companies.

II

APPROACHES THAT MAY BE USED TO PROVIDE A VETO

A. Available Devices

If there is a business need for a veto and the lawyer does not look into possible methods of providing it, he is not adequately serving his client. In most jurisdictions, an effective veto can be provided. This paper examines two of the rather numerous devices that are available for use:[7] namely, (1) charter and by-law provisions requiring unanimity or concurrence of a high percentage of voting units for shareholder or director action; and (2) charter and by-law provisions fixing high attendance requirements for quorums at meetings of shareholders and directors. In many situations, charter and by-law provisions of these two types offer the easiest and most effective means of providing a veto. Other veto devices will be discussed in this paper only in so far as they are serviceable in strengthening or supporting these two methods of achieving a veto.

B. The Business Situation and Statutory Requirements

Before drafting veto provisions, the lawyer must carefully study the veto problem in relation to the particular business situation with which he is working. He must consider the nature and scope of the enterprise, the number of persons who are to participate in it, the contributions in money, credit, or services that each participant is to make, the personalities and business skills of the participants, the number and identity of persons who are to have veto powers, the activities to which the veto is to apply, and, of course, the preferences of the participants.

Veto provisions require original composition. Clauses in standard forms can at most serve only as "idea guides."[8] In the first place, standard forms usually are prepared with widely held corporations in mind, most often with the aim of giving directors and management as much power and freedom from shareholder control as possible. That aim is of course directly opposed to the objective sought by veto provisions.[9] Secondly, each participant in a closely held enterprise usually has his own ideas on what his relation to the business should be; and therefore each provision on management must be individual.

[7] Devices and arrangements not discussed in this paper which may be found serviceable in establishing a veto are: (1) classification of shares into voting and non-voting stock, with voting shares distributed in a way to give a balance of voting power and thus a veto, (2) classification of directors, (3) voting agreements and other shareholder agreements, (4) voting trusts, and (5) irrevocable proxies.

[8] See PANTZER AND O'NEAL, THE DRAFTING OF CORPORATE CHARTERS AND BY-LAWS §§2.03-.04 (1951).

[9] The use of forms in drafting the charter and by-laws also raises the danger that provisions inconsistent with the veto clauses will inadvertently be inserted in other parts of the charter or by-laws. See Kear v. Levinson, 71 D. & C. 475 (Pa. Com. Pl. 1950), where a by-law provision was held to have superseded a promoters' agreement entered into before incorporation.

The lawyer must of course carefully study the corporation statutes of the jurisdiction in which the enterprise is to be incorporated. Those statutes determine the legality of shareholder veto, the activities that may be subjected to veto, the instruments in which the veto provisions must be placed to be effective, and the approach that must be taken (and sometimes the phraseology that must be used) to provide the veto. Typical statutory provisions affecting the legality and efficacy of veto provisions are discussed in another section of this paper.[10] In some instances, in order to provide an effective veto, the lawyer will have to incorporate the enterprise in a state other than the one in which it is to conduct its principal business.

C. Division of Decision-Making Power Among Shareholders, Directors, and Officers

As has been mentioned, participants in a closely held enterprise may want power to veto fundamental corporate changes, important business policies, decisions in the day-to-day operation of the business, or all of these. A requirement of unanimity or of an unsually high vote for shareholder action, for director action, or for both will usually be sufficient to give the veto desired. Occasionally, a high requirement for shareholder or director action must be used in combination with other charter or by-law provisions to achieve a desired veto.

In most jurisdictions, a veto over fundamental changes in the corporate structure can easily be accomplished. Modern corporation statutes provide for shareholder participation in fundamental corporate acts such as charter amendment, merger, consolidation, dissolution, and sale of all assets. A charter provision requiring unanimity for all shareholder action or for those particular acts (assuming that it is properly protected against amendment) will give each shareholder an effective veto over fundamental corporate changes. Similarly, a provision requiring approval of holders of a high percentage of the shares for shareholder action can be used to provide a veto over fundamental acts. For instance, a requirement of approval of holders of 75 per cent of the shares obviously empowers a person holding 30 per cent of the shares to prevent shareholder action—that is, if the requirement is protected against circumvention through the issuance of additional stock.[11]

A high vote requirement for shareholder action can also be used in some instances to protect a shareholder against corporate acts other than major changes in the corporate structure. Here is a simple illustration of how a high vote requirement can be used in combination with other charter provisions to meet a business need for a veto over certain corporate acts. Assume that a corporation is being organized under Missouri law to take over several existing businesses. The most important of the businesses belongs to Black, who is to receive 35 per cent of the corporation's total authorized shares. Black wants protection against dilution of his interest in the corporation by the subsequent issuance of no-par shares to other persons transferring properties to the corporation in exchange for shares. One method of afford-

[10] See *infra* page 457.
[11] See *infra* page 470.

ing protection is through appropriate provisions in the articles of incorporation (1) reserving to shareholders the right to fix the consideration to be received for shares without par value, (2) requiring approval of holders of 75 per cent of the outstanding shares for shareholder action fixing the consideration to be received for shares without par value, and (3) requiring a 75 per cent vote for amendment of the articles of incorporation. As the corporation under this arrangement cannot issue additional no-par stock over the dissenting vote of Black's shares, Black (although a minority shareholder) is protected against dilution of the value of his holdings.[12]

High voting requirements for shareholder action, however, usually do not give the power to veto important policy matters such as changes in officers' salaries, or the day-to-day conduct of business. To provide a veto over those kinds of decisions, unanimity or a high vote must be required for director action, and the shareholders for whom a veto is sought must be assured representation on the board of directors. Further, it may be necessary to define narrowly in the charter or the by-laws the authority and duties of corporate officers; otherwise corporate officers may be given authority to perform without director approval acts against which a veto is desired.

Whenever a shareholder has sufficient voting strength to keep a representative on the board, a requirement of unanimity for board action of course gives that shareholder the effective power to veto action within the province of the board. Representation on the board can usually be assured a minority shareholder by the use of cumulative voting or by classifying the shares and providing for election of some directors by one class of shares and other directors by a second class of shares. Another possible method of assuring that a shareholder will have representation on the board is to name the original board in the charter and to require unanimous approval of the shareholders for the election of new board members. This arrangement results in holding over the directors in office if shareholders cannot agree on a new board. Statutes, charters or by-laws not uncommonly provide that directors are to serve until their successors are elected. In some jurisdictions, however, an arrangement of this sort may be invalid.[13]

Whenever a shareholder cannot be assured representation on the board or whenever for any reason an effective veto of board action cannot be given,[14] a veto of matters ordinarily within the province of the board can sometimes be provided by transferring decision-making power over those matters from the directors to the shareholders[15] and then requiring unanimity or a high vote for shareholder action.

[12] This illustration is based on one given in an address by Robert B. Fizzell, of the Kansas City, Missouri, Bar, before the Lawyers Association of Kansas City, April 26, 1949.

[13] See ISRAELS AND GORMAN, CORPORATE PRACTICE 22 (1953).

[14] In some jurisdictions, charter and by-law provisions requiring a high vote for director action are somewhat less likely to be sustained than are similar requirements for shareholder action; statutory authority supporting high requirements for director action is not as abundant and sometimes it is not as free from ambiguity as that supporting high requirements for shareholder action. *Compare* the statutory materials discussed in Section III(A)(2) of this paper *infra* page 458, *with* those discussed in Section III(A)(3) *infra* page 459.

[15] But see the admonition in ISRAELS AND GORMAN, CORPORATE PRACTICE 23 (1953), against vesting power of control in places different from those contemplated by statute.

In Iowa, for example, power to make all corporate decisions apparently can be vested in the shareholders, for the corporation statute of that state does not require a board of directors.[16] In most states, however, the blanket transfer of *all* corporate power to the shareholders (completely eliminating the customary functions of the board of directors) probably would not be sustained. In the first place, the great majority of corporation statutes contain sections that vest in the board of directors the management of the corporation and the control of ordinary corporate affairs.[17] Further, some statutes contain provisions conferring on the board the power to perform specified acts, *e.g.*, the selection of corporate officers.[18] In some jurisdictions, the control vested in the directors by these statutes apparently cannot be either transferred to the shareholders or limited by a requirement that the shareholders must ratify action taken by the directors before it will be operative.[19]

On the other hand, under many corporation statutes the charter or by-laws may determine whether certain corporate acts are to be performed by the shareholders or by the directors. The Pennsylvania statute, for instance, states that "unless the articles or by-laws provide otherwise, the board of directors shall elect and fix the compensation" of officers and assistant officers.[20] Thus, if the shareholders want a veto over the selection of corporate officers and the fixing of their salaries, a clause can be inserted in the charter providing that the shareholders shall elect the officers and fix their salaries and that this action can be taken only by a unanimous vote or by a specified vote greater than a majority. Similarly, under the laws of a number

[16] See Ballard, *Arrangements for Participation in Corporate Management under the Pennsylvania Business Corporation Law*, 25 TEMP. L. Q. 131, 132 (1951), citing IOWA CODE §§491.2, 491.3(7), 491.5 (1950). ". . . other than as a matter of convenience and policy nothing in the nature of the corporation requires having a board of directors or committing to such a board the management of corporate affairs. . . ." Ballard, *supra*, at 132.

[17] *E.g.*, ILL. ANN. STAT. c. 32, §157.33 (1935); IND. ANN. STAT. §25-208 (Burns, 1933); PA. BUS. CORP. L. tit. 15, §2852-401 (1951). Section 33 of the Model Business Corporation Act provides that the "business and affairs of a corporation shall be managed by a board of directors." Section 31(I) of the Uniform Business Corporation Act vests control in the directors in even stronger terms; that section states: "The business of *every* corporation shall be managed by a board of at least three directors. . . ." (italics supplied). But see Section 31 (III) of the Uniform Act. On the other hand, DEL. REV. CODE §2041 (1935) appears to provide for flexibility by stating: "The business of every corporation . . . shall be managed by a Board of Directors, except as hereinafter or in its Certificate of Incorporation otherwise provided."

[18] See LA. GEN. CORP. L. §35 (1938) (the board "shall elect a president, a secretary and a treasurer").

[19] See Security Savings & Trust Co. v. Coos Bay Lumber & Coal Co., 219 Wis. 647, 263 N. W. 187 (1935), declaring invalid a by-law that required shareholder consent only for specified acts within the province of the directors, namely, the payment of officers and employees. *Cf.* Warren v. 536 Broad Street Corp., 4 N. J. Super. 584, 68 A. 2d 175 (1949), *aff'd*, 6 N. J. Super. 170, 70 A. 2d 782 (1950), where the court held that a clause in the charter calling for approval of 75 per cent of the shares before corporate real estate could be leased was subject to amendment but intimated that the clause was valid.

[20] PA. BUS. CORP. L. §406 (1951). See also PA. BUS. CORP. L. tit. 15, art. VI, §2852-601 (1951), which states: "Unless the articles or by-laws otherwise provide, the board of directors shall have the power, by resolution duly adopted, to issue from time to time, in whole or in part, the kinds or classes of shares authorized in the articles." Under this provision, the articles or by-laws apparently could provide either that the shareholders will have the exclusive right to issue stock or that approval of both directors and shareholders will be necessary. Note that in the illustrative problem discussed *supra* page 454 the first step toward a solution was placing in the charter a provision reserving to the shareholders the right to fix the compensation to be received for shares without par value.

of states the charter may require shareholder consent for the execution of corporate mortgages.[21]

III

STATUTES SUPPORTING HIGH VOTE REQUIREMENTS

A. Statutes Authorizing Provisions in the Charter

1. *Statutes Applicable to Both Shareholder and Director Action.* Most corporation statutes authorize in broad terms the inclusion in the charter of special or optional provisions regulating the conduct of corporate affairs. A number of these statutes list the required contents of the charter and simply add that the charter may contain "any provisions not inconsistent with law which the incorporators may choose to insert for the regulation of the internal affairs of the corporation and the business of the corporation."[22] Other statutes are somewhat more wordy. The Delaware statute is perhaps typical. It states that the articles may contain "any provision which the incorporators may choose to insert for the management of the business and for the conduct of the affairs of the corporation, and any provisions creating, defining, limiting and regulating the powers of the corporation, the directors and the stockholders, or any class of the stockholders."[23]

These general statutory provisions authorizing special charter clauses appear on their face to permit great flexibility in charter drafting and to furnish ample authority for inserting clauses requiring unanimity or a greater than customary vote for shareholder and director action. On the basis of these statutes alone, however, the assumption must not be too readily made that clauses of that type can be safely inserted in the charter. In most jurisdictions, the courts have not as yet interpreted these broadly worded statutes to determine just what charter provisions are authorized.[24] Further, most of the statutes authorizing special provisions limit the authorization to "lawful provisions," "provisions not inconsistent with law," or provisions which do not exempt shareholders, directors or members "from the per-

[21] *E.g.*, CAL. CORP. CODE §3900 (1948); TENN. CODE §3748 (Michie, 1932). See also Note, 51 HARV. L. REV. 1074 (1938). In the absence of statute, authority to execute corporate mortgages is vested in the directors alone, but apparently a charter provision requiring shareholder consent is valid. Liverpool & London & Glove Ins. Co. v. Aleman Planting and Mfg. Co., 166 La. 457, 117 So. 554, 556-7 (1928); Bishop v. Kent & Stanley Co., 20 R. I. 680, 41 Atl. 255 (1898).

[22] *E.g.*, PA. BUS. CORP. L. §204. See also ILL. STAT. c. 32, §157.47(1) (Smith-Hurd, Supp. 1952); MO. REV. STAT. §351.055 (1949).

[23] DEL. GEN. CORP. L. §5(8). See also, sections 5(11), 13, and 17 of that statute. N. Y. GEN. CORP. L. §13(2) states that a corporation's certificate of incorporation may contain "any provision for the regulation of its business and the conduct of its affairs, and any limitation upon its powers, or upon the rights of its stockholders or upon the power of its directors and members, which does not exempt them from the performance of any obligation or duty imposed by law." OHIO. GEN. CODE §8623-4(8) (Supp. 1952) provides that "any lawful provisions which may be desired for the purpose of defining, limiting and regulating the exercise of the authority of the corporation, or of the directors or of all the shareholders" may be included in the articles and that "any provision authorized to be made in the regulations of a corporation may, if desired, be made in its articles."

[24] See BALLANTINE, CORPORATIONS §46 (rev. ed. 1946); BALLANTINE AND STERLING, CALIFORNIA CORPORATION LAWS §37 (1949 ed.). For interesting cases on the legality and effect of optional provisions in the articles, see Union Trust Co. of Maryland v. Carter, 139 Fed. 717 (C.C.W.D. Va. 1905); State ex rel. Ross v. Anderson, 31 Ind. App. 34, 67 N. E. 207 (1903).

formance of any obligation or duty imposed by law." These vague phrases may encourage courts to hold charter veto clauses unlawful as violative of other statutes or as inconsistent with the established scheme of corporate management or contrary to some obscure public policy.[25]

In most states, reliance does not have to be placed solely on the statutes authorizing special provisions; other and more specific statutes also support the validity of high vote requirements. Perhaps the best known of the statutes expressly applicable to high vote requirements is Section 9 of the New York Stock Corporation Law.[26] That statute, enacted on the recommendation of the New York Law Revision Commission, was hailed at the time of its passage as the first important legislative recognition of the special management needs of closely held corporations.[27] It provides that (subject to compliance with certain requirements of consent by shareholders) the certificate of incorporation[28] can impose high quorum requirements for shareholders' meetings and for directors' meetings, and can require unanimity or a vote greater than a majority for shareholder and director action. Section 9 originally limited the validity of veto provisions of this kind to ten years, after which they could be renewed for one or more ten year periods. As amended,[29] however, that statute apparently permits these arrangements to remain in effect for an unlimited period of time.

2. *Statutes Applicable Solely to Shareholder Action*. Many modern corporation acts expressly authorize charter provisions requiring a high vote for shareholder action. The Delaware statute, for instance, provides that the certificate of incorporation may contain "provisions requiring for any corporate action the vote of a larger proportion of the stock or of any class thereof than is required by this Chapter."[30] Similarly, the Model Business Corporation Act[31] contains a section which states:[32]

> Whenever, with respect to any action to be taken by the shareholders of a corporation, the articles of incorporation require the vote or concurrence of the holders of a greater proportion of the shares, or of any class or series thereof, than required by this Act with respect to such action, the provisions of the articles of incorporation shall control.

Statutes substantially the same as this provision from the Model Act can be found in the laws of a number of important commercial jurisdictions,[33] and no case has

[25] See Kaplan v. Block, 183 Va. 327, 31 S. E. 2d 893, 897 (1944), discussed *infra* page 461.

[26] N. Y. Stock Corp. Law §9 added by N. Y. L. c. 862, §1 (1948), amended by N. Y. L. c. 261 (1949) and N. Y. L. c. 717, §1 (1951).

[27] Capriles and Reichardt, *1947-1948 Survey of New York Law—Corporations*, 23 N. Y. U. L. Q. REV. 747 (1948).

[28] Note should be taken of the fact that Section 9 does not provide for the imposition of high quorum or voting requirements by shareholders' agreement or by-law provision.

[29] N. Y. L. c. 717, §1 (1951).

[30] DEL. GEN. CORP. L. §5 (11). See also DEL. GEN. CORP. L. §17.

[31] Prepared by the Committee on Business Corporations of the Section of Corporation, Banking and Business Law of the American Bar Association.

[32] MODEL BUSINESS CORP. ACT §136 (1950).

[33] *E.g.*, ILL. STAT. c. 32, §157.146 (1935); MO. REV. STAT. §351.270 (1949). The Ohio statute, OHIO GEN. CODE §8623-49 (1938), states: "Notwithstanding any provision of this act requiring for any purpose the vote of a designated porportion of the voting power of a corporation, or of any class

been found in which the validity of this kind of statute has been challenged.[34]

Some states have statutory provisions permitting a high vote requirement for *specified* shareholder action. Representative statutes of this kind require a stated shareholder vote for charter amendment, consolidation, merger, and sale of assets, but add that the stated vote may be increased by charter provision.[35] A particular jurisdiction may have this kind of statute in lieu of, or in addition to, a statute authorizing a high vote requirement for any shareholder action.

3. *Statutes Applicable Solely to Director Action.* In many jurisdictions, the corporation statutes expressly state that the charter many require greater than a majority vote for director action. The Model Business Corporation Act[36] and the corporation laws of a number of important jurisdictions[37] contain a section which states that the "act of the majority of the directors present shall be the act of the board of directors, unless the act of a greater number is required by the articles of incorporation or the by-laws." This language seems clearly to authorize inclusion in the charter of provisions requiring the vote of more than a majority of the directors present for any director action or for particular kinds of action. Even in jurisdictions in which the corporation statute does not contain this clear authorization, a charter provision requiring a high director vote would probably be given effect.[38]

B. Statutes Authorizing Provisions in the By-Laws

The corporation statutes in many states contain general provisions (similar to those inviting the inclusion of special clauses in the charter) which seem sufficiently broad to authorize the insertion in the by-laws of provisions requiring unanimity or a high percentage vote for director action and perhaps for shareholder action. Some statutes provide that the by-laws may include "any lawful provisions which may be desired for the purpose of defining, limiting and regulating the exercise of authority of the corporation, or of the directors or of all the shareholders."[39] Other statutes state that the by-laws may contain "any provisions for the regulation

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or classes of the shares thereof, the articles of a corporation may provide that such action may be taken by the vote of a greater or less proportion of such voting power of such corporation, or by the vote of any class or classes of the shares thereof than that so required by this act, but, unless expressly permitted by this act such proportion shall not less than a majority." "Voting power" in this provision undoubtedly refers solely to voting by shareholders, not to voting by directors; this is suggested by the context, this provision being in that portion of the act relating to shareholders.

[34] Aldridge v. Franco Wyoming Oil Company, 24 Del. Ch. 349, 14 A.2d 380 (1940), however, has the effect of limiting the Delaware statute. See discussion of that case *infra* page 467.

[35] See, *e.g.*, WIS. BUS. CORP. L. §§180.51, 180.64, 180.71 (1951). *Cf.* OHIO GEN. CODE §8623-15 (1938).

[36] Section 37.

[37] *E.g.*, ILL. STAT. c. 32, §157.37 (Smith-Hurd, 1935); OHIO GEN. CODE §8623-58 (1938); WIS. BUS. CORP. L. §180.35 (1951).

[38] "Apart from statute . . . there is nothing in the nature of the corporation to prevent the shareholders from committing the management of the company's business and affairs to a board or other select group, but requiring that such board can act with legal effect only with unanimity." Ballard, *Arrangements for Participation in Corporate Management Under the Pennsylvania Business Corporation Law*, 25 TEMP. L. Q. 131, 152 (1951).

[39] *E.g.*, OHIO GEN. CODE §8623-12 (Supp. 1952).

and management of the affairs of the corporation not inconsistent with law or the articles of incorporation."[40] Further, in some states the corporation statute contains provisions that even more clearly indicate that high vote requirements may be inserted in the by-laws. A typical provision states that the act "of the majority of the directors present at a meeting at which a quorum is present shall be the act of the board of directors, unless the act of a greater number is required by . . . the by-laws."[41]

IV

UNFAVORABLE STATUTES AND DECISIONS

The validity of charter and by-law provisions requiring unanimity or a high vote for shareholder or director action may be challenged on the ground that they (1) contravene statutory provisions specifying the shareholder or director vote necessary for particular corporate acts, (2) are inconsistent with the general scheme of corporate management,[42] or (3) violate public policy in that they make difficult the conduct of corporate business and may lead to corporate paralysis.[43]

In most states, challenges of this kind have little chance of prevailing because of the clearly worded statutes (discussed in the preceding section of this paper) authorizing charter or by-law requirements fixing a high vote for shareholder and director action. In a few jurisdictions, however, such requirements if challenged would probably be held invalid. In one or two states, the corporation statute contains provisions on shareholder or director voting so worded that the courts may well conclude that the voting procedures there set forth are inflexible and that voting requirements cannot be increased by charter or by-law provision. The New Jersey statute is an example. It lays down procedures to be followed in charter amendment, merger, consolidation, dissolution, and similar corporate action,[44] an essential step in each of these procedures being a favorable vote of a specified percentage of the shares or of the shares with voting power. In each instance the voting requirement is couched in language which appears to permit no variation.[45] Further, the New Jersey courts have indicated rather positively that they will not permit a modification of the statutory vote.[46]

[40] *E.g.*, MO. REV. STAT. §351.290 (1949). *Cf.* PA. BUS. CORP. L. §304 (1951).

[41] ILL. STAT. c. 32, §157.37 (1935); OHIO GEN. CODE §8623-58 (1938); WIS. BUS. CORP. L. §180.35 (1951).

[42] See Jackson v. Hooper, 76 N. J. Eq. 592, 75 Atl. 568, 571 (1910).

[43] See Kaplan v. Block, 183 Va. 327, 31 S. E. 2d 893, 896-7 (1944). In commenting on Benintendi v. Kenton Hotel, 294 N. Y. 112, 60 N. E. 2d 829 (1945), discussed *infra* page 462, the Attorney General of New York stated: "It seems to me that the essence of the decision is to the effect that since requirements for unanimity in matters involving the stockholders' and directors' activities render it virtually impossible to conduct the normal operations of the corporation, they are, in the absence of specific statutory authority therefor violative of the public policy of this State." Op. Att'y Gen. (N. Y.) to Sec'y of State (12-14-48).

[44] N. J. REV. STAT. §§14:11-2, 14:12-2, 14:12-3, 14:13-1 (1937).

[45] *E.g.*, "If two-thirds in interest of each class of stockholders having voting powers shall vote in favor of such amendment, change or alteration, the corporation shall make a certificate thereof. . . ." N. J. REV. STAT. §14:11-2 (1937).

[46] "Our Corporation Act provides . . . that a vote of two-thirds of the holders is sufficient for

Note should be taken of the fact that the New Jersey laws contain a typical provision authorizing the inclusion of special provisions in the certificate of incorporation.[47] The New Jersey courts, however, have not referred to that provision when they have discussed the legality of charter and by-law stipulations varying the statutory votes, and apparently they do not think that it is pertinent to the problem.

Even in states with corporation laws which in general permit great flexibility in the management pattern, clauses requiring unanimity or a qualified majority may be of questionable validity if applied to some corporate acts. For example, the Pennsylvania corporation statute, which in general allows considerable flexibility, contains a section[48] that reads as follows:[49]

> *No business corporation shall increase its indebtedness, except in the manner provided in this section.* The board of directors of the corporation shall adopt a resolution setting forth the desired increase, and directing that the question of the proposed increase be submitted to a vote at an annual meeting of the shareholders or at a special meeting of the shareholders. . . . The resolution shall be adopted upon receiving the affirmative vote of the holders of at least a majority of the outstanding shares. . . . [italics supplied].

The courts might invalidate a charter or by-law provision requiring a higher shareholder vote than one set forth in this section. Perhaps a point that should be made here is that the lawyer planning veto provisions cannot safely rely on general statutory provisions that seem to permit unlimited flexibility in charter or by-law clauses; he must comb the laws of the state for other statutory provisions which lay down rigid procedures for particular types of corporate action and can be interpreted as limiting the more general and less rigid provisions.

Among the courts which have shown hostility to provisions requiring approval by a high percentage of shareholders or directors for effective corporate action is the Virginia Court of Appeals. In *Kaplan v. Block*,[50] that court held invalid a charter provision providing that acts of the board of directors were not to bind the corporation or the shareholders until they were ratified by the unanimous vote of holders of outstanding stock.[51] The Virginia corporation statute contained at the time of this decision, as it still does, a provision permitting inclusion in the certificate of in-

amendments of the certificate of incorporation, dissolution, merger, and other important corporate matters. . . . A certificate or by-laws which would require unanimous vote on these matters would be subversive of the statute." Clausen v. Leary, 113 N. J. Eq. 324, 166 Atl. 623, 625 (1933). This language was referred to with approval in Warren v. 536 Broad Street Corporation, 4 N. J. Super. 584, 68 A. 2d 175, 180 (1949), *aff'd*, 6 N. J. Super. 170, 70 A.2d 782 (1950). See also Jackson v. Hooper, 76 N. J. Eq. 592, 75 Atl. 568, 571 (1910).

[47] N. J. REV. STAT. §14:2-3 (1937).

[48] PA. BUS. CORP. L. §309 (1951).

[49] *With* this provision *compare* PA. BUS. CORP. L. §311(B) (voluntary transfer of corporate assets), §902 (approval of joint plan of merger or consolidation), §1102 (voluntary dissolution). For sections of the Pennsylvania statute indicating clearly that the statutory procedure there fixed can be modified, see PA. BUS. CORP. L. §304, §406 (electing and fixing the compensation of officers), §503 (quorum of shareholders), §601 (issuance of stock), §805 (amendment of articles by shareholders).

[50] 183 Va. 327, 31 S. E. 2d 893 (1944).

[51] *Compare* Kaplan v. Block, *with* Union Trust Co. of Maryland v. Carter, 139 Fed. 717 (C.C.W.D. Va. 1905), upholding a charter provision by which the shareholders in a Virginia corporation bound themselves in advance to affirm for a specified period of time all acts of the directors.

corporation of optional clauses "creating, defining, limiting or regulating the powers of the corporation, of the directors or of the stockholders."[52] Further, the section of the corporation statute that defined the powers of the board of directors clearly indicated that those powers could be modified by "any by-law or regulation of the stockholders."[53] In spite of these statutory provisions, the Court of Appeals asserted that "the board of directors must direct the business, and govern the policy and plans of the corporation," and declared the charter provision void as an attempt to "sterilize" the board of directors.[54]

Although the charter provision in the *Kaplan* case is easily distinguished from one requiring unanimity or a high percentage vote for shareholder action, considerable language in that case and some of the materials quoted with approval in that decision suggest that the court would not have sustained a requirement of unanimity or high vote. In particular, the court recognized a "right" of majority rule in corporate affairs;[55] and, after discussing business considerations against giving a single individual power to render the corporation helpless, it asserted unequivocally that charter provisions giving such a power "violate both common and statute law and are suicidal of corporate existence."[56]

Benintendi v. Kenton Hotel[57] has been overruled by statute,[58] but the reasoning of that decision is still significant because the approach there taken may be followed by courts in jurisdictions where the legislature has not spoken. In that decision, the New York Court of Appeals held invalid (1) a by-law requiring unanimity for shareholders' resolutions, (2) a by-law requiring unanimity for the election of directors, and (3) a by-law requiring unanimity for directors' resolutions.[59] The three by-laws were thought to be inconsistent with controlling corporation statutes. By-law (1), requiring unanimity for shareholder action, was "obnoxious to the statutory scheme of stock corporation management."[60] Among other things, it violated statutes[61] fixing stated percentage votes for specified resolutions, *e.g.*, resolutions in proceedings to change a corporation's capitalization or to dissolve it. By-law (2), requiring a unanimous stock vote for the election of directors, was also

[52] VA. CODE §13-24(9) (Michie, 1950).

[53] VA. CODE §13-200 (Michie, 1950).

[54] "To ask that directors be divested of all power and that without the consent of every stockholder no one should have the power to do anything is to ask too much." 31 S. E. 2d at 897. The court relied heavily on an earlier decision, Sterling v. Trust Co. of Norfolk, 149 Va. 867, 141 S. E. 856 (1928).

[55] 31 S. E. 2d at 896.

[56] *Id.* at 896-897.

[57] 294 N. Y. 112, 60 N. E. 2d 829 (1945).

[58] See N. Y. STK. CORP. L. §9, discussed *supra* page 458. The statement in the text is not entirely accurate. The *Benintendi* decision invalidated veto provisions in the by-laws but on grounds broad enough to invalidate also veto provisions in the charter. The statute authorized the insertion of veto provisions in the charter.

[59] The doctrine of the *Benintendi* case was later extended to by-laws requiring less than unanimity but more than a majority. Christal v. Petry, 301 N. Y. 562, 93 N. E. 2d 450 (1950); Eisenstadt Bros. v. Eisenstadt, 89 N. Y. S. 2d 12 (Sup. Ct., Spec. T., Queens Co. 1949). But see Kronenberg v. Sullivan County Steam Laundry Co., 91 N. Y. S. 2d 144 (Sup. Ct., Sullivan Co. 1949).

[60] ". . . this State has decreed that every stock corporation chartered by it must have a representative government, with voting conducted conformably to the statutes. . . ." 60 N. E. 2d at 831.

[61] N. Y. STK. CORP. L. §§36, 37; N. Y. GEN. CORP. L. §102.

held to violate a statutory norm, namely a section of the Stock Corporation Law providing that directors shall be chosen by a plurality of the votes cast.[62] By-law (3), requiring unanimity for directors' acts, was referred to as "almost as a matter of law, unworkable and unenforcible," and was held to violate the statutory scheme of corporate management established by Sections 27 and 28 of the New York General Corporation Law. This conclusion was reached in spite of language in each of those sections which seemingly permitted departure from the statutory pattern.[63]

Although the veto provisions declared invalid in the *Benintendi* case were in the by-laws, the reasoning of the decision was broad enough to invalidate those provisions even had they been included in the charter.[64] The majority opinion did not mention New York statutes authorizing the inclusion of special clauses in the certificate of incorporation[65] and permitting voting rights to be spelled out in the charter.[66] The members of the court, however, undoubtedly were well aware of those statutes;[67] and apparently the majority judges were of the opinion that in spite of those statutes the broad principles laid down in the decision were applicable to charter provisions as well as to by-laws.[68]

[62] N. Y. STK. CORP. L. §55. The court cited with approval *In re* Boulevard Theatre & Realty Co., 195 App. Div. 518, 186 N. Y. S. 430 (1st Dep't 1921), *aff'd*, 231 N. Y. 615, 132 N. E. 910 (1921), and *In re* Election of Directors of Rapid-Transit Ferry Co., 15 App. Div. 530, 44 N. Y. S. 539 (2d Dep't 1897), cases which respectively invalidated a charter provision and a by-law provision as being inconsistent with Section 55.

[63] Section 27 reads as follows: "The business of a corporation shall be managed by its board of directors. . . . *Unless otherwise provided* a majority of the board at a meeting duly assembled shall be necessary to constitute a quorum for the transaction of business and the act of a majority of the directors present at such a meeting shall be the act of the board. The by-laws may fix the number of directors necessary to constitute a quorum at a number less than a majority of the board, but not less than one-third of its number" (italics supplied). Perhaps the court was of the opinion that the phrase "Unless otherwise provided" applied only to the clause immediately following it and not to that part of the sentence which provides for majority action by directors. That interpretation would permit flexibility in fixing the quorum (subject to the limitation in the last sentence of the quoted extract) but would not allow variation in the voting requirement. On the other hand, the section could easily have been interpreted to grant flexibility in setting both quorum and voting requirements, subject to the single exception that the quorum could not be reduced below one-third.

Section 28 seems to provide even more clearly for flexibility. That section states that whenever "under the provisions of any corporate law a corporation is authorized to take any action by its directors, action may be taken by the directors, regularly convened as a board, and acting by a majority of a quorum, *except when otherwise expressly required by law or the by-laws. . . .*" (italics supplied). Statutory provisions similar to Sections 27 and 28 are to be found in the laws of other states. See, *e.g.*, PA. BUS. CORP. L. §402(5) (1951).

[64] Note for example the following language: "That whole concept [representative corporate government conformable to statute] is destroyed when the stockholders, by agreement, by-law or certificate of incorporation provision as to unanimous action, give the minority interest an absolute, permanent, all-inclusive power of veto." 60 N. E. 2d at 831. See also Eisenstadt Bros. v. Eisenstadt, 89 N. Y. S. 2d 12, 13 (Sup. Ct., Spec. T., Queens Co. 1949).

[65] N. Y. GEN. CORP. L. §13(2).

[66] N. Y. STOCK CORP. L. §§11, 51.

[67] See the dissenting opinion in Benintendi v. Kenton Hotel, 294 N. Y. 112, 60 N. E. 2d 829, 832, 834-5 (1945).

[68] But note the following extract from Op. Att'y Gen. (N. Y.) to Sec'y of State (12-14-48): "The provisions of the corporation laws of this State which have long been deemed to authorize requirements for stockholder approval in excess of that which would otherwise be necessary, namely, §§11 and 51 of the Stock Corporation Law and §13 of the General Corporation Law, were not cited to the court in the Benintendi case or referred to in its decision. Therefore, it would not appear that the Benintendi decision invalidated the certificate provisions here involved."

V

HIGH QUORUM REQUIREMENTS FOR SHAREHOLDERS' AND DIRECTORS' MEETINGS

Many corporation statutes authorize charter or by-law provisions fixing high quorum requirements for meetings of shareholders and directors,[69] and provisions of that kind are probably valid even in the absence of statutory authorization. Therefore, some draftsmen, with a view to conferring a veto, insert in the charter or by-laws provisions requiring the presence of a high percentage of shareholders or directors for quorums for the transaction of any business or of designated kinds of business. To protect shareholders or directors against their appearing inadvertently at a meeting that is to consider action they oppose, the high quorum requirement must be buttressed by a requirement that notices of meetings state the business that is to be transacted. Otherwise, a shareholder or director may attend a meeting, help form a quorum, and thus permit action on a matter he opposes.

Many lawyers apparently are of the opinion that the use of both high quorum and high vote requirements sets up a double hurdle that objectionable action must clear before it will be operative. Actually, this double obstacle is an illusion. If a shareholder or director refrains from attending a meeting in order to prevent the forming of a quorum, he of course never gets an opportunity to veto a proposal by voting against it. In most situations, it is preferable to rely solely on a high vote requirement. That permits shareholders or directors in apparent disagreement to get together, discuss their differences, and possibly discover areas of agreement or evolve policies satisfactory to all.

A few statutes, however, contain provisions that suggest a possibly sound reason for the practice of using both high quorum and high vote requirements. For example, some corporation statutes contain a section[70] that reads:

> Whenever, with respect to any action to be taken by the shareholders of a corporation, the articles of incorporation require the vote or concurrence of the holders *of a greater proportion of the shares,* or of any class or series thereof, than required by this Act with respect to such action, the provisions of the articles of incorporation shall control. [italics supplied].

In view of this statutory language, there is some doubt that a requirement of unanimity for shareholder action (as distinguished from a requirement of a high percentage vote) is valid. The words "greater proportion" could conceivably be given a narrow, literal interpretation that would exclude by implication the use of requirements of unanimity. The language of most statutory provisions authorizing an increase in quorum requirements is not open to this narrow interpretation.[71]

[69] *E.g.,* MO. REV. STAT. §§351.265, 351.325 (1949); N. Y. STK. CORP. L. §9; WIS. BUS. CORP. L. §§180.28, 180.35 (1951).

[70] MODEL BUS. CORP. ACT §136 (1950); WIS. BUS. CORP. L. §180.90 (1951). See also DEL. CORP. L. §5(11); OHIO. GEN. CODE ANN. §8623-49 (1938).

[71] See, *e.g.,* MODEL BUS. CORP. ACT §30 (1950).

VI

WHERE VETO PROVISIONS SHOULD BE PLACED

Provisions requiring a high vote or setting high quorum requirements ordinarily should be placed both in the charter and in the by-laws. There are a number of reasons for inserting provisions of that kind in the charter. If they are included in the charter, express statutory authority can usually be found to support their validity.[72] As a matter of fact, some statutes clearly indicate that certain veto provisions will not be effective unless they are in the charter.[73] Further, some courts seem to be more willing to sustain veto provisions if they are in the charter than if they are in the by-laws.[74]

In most situations, veto provisions should also be included in the by-laws. Some cases have held that in the absence of statutory permission the provisions of the charter must be confined to those required by law and that additional clauses inserted in the articles will be treated as surplusage.[75] As the corporation statutes of some states do not expressly authorize special charter provisions, there is some danger that special provisions in charters of corporations formed in those states will not be given effect. Further, some corporation statutes refer only to the use of by-law provisions as a method of increasing voting or quorum requirements for director action; they do not mention variation by charter provision. An example is the Pennsylvania statute, which contains a section stating that "except as otherwise provided in the by-laws . . . a majority of the directors in office shall be necessary to constitute a quorum for the transaction of business, and the acts of a majority of the directors present at a meeting at which a quorum is present shall be the acts of the board of directors."[76] The inference could easily be drawn from this statute that increased quorum or voting requirements for action by the directors, irrespective of whether they are included in the charter, will not be effective unless stated in the by-laws. Thus, the interesting point is made that in some jurisdictions provisions designed to afford a veto over some kinds of corporate action, *e.g.*, changes in salaries or other action within the province of the directors, have greater statutory support if inserted in the by-laws; while provisions giving a veto over other kinds of action, *e.g.*, fundamental changes in the corporate structure that require a shareholder vote, have stronger statutory support if they are included in the charter.[77]

[72] *E.g.*, DEL. GEN. CORP. L. §5(11); N. Y. STK. CORP. L. §9; OHIO GEN. CODE ANN. §8623-49 (1938); WIS. BUS. CORP. L. §180.90 (1951).

[73] *E.g.*, PA. BUS. CORP. L. §503 (1951); WIS. BUS. CORP. L. §180.28 (1951). See Ballard, *Arrangements for Participation in Corporate Management Under the Pennsylvania Business Corporation Law*, 25 TEMP. L. Q. 131, 162-163 (1951).

[74] *Compare* Benintendi v. Kenton Hotel, 294 N. Y. 112, 60 N. E. 2d 829 (1945) (holding invalid by-laws requiring unanimity for shareholder or director action), *with* Ripin v. Atlantic Mercantile Co., 205 N. Y. 442, 98 N. E. 855 (1912) (sustaining a charter provision stating that the number of directors could not be changed except by unanimous consent of the shareholders). The decision in the *Ripin* case was grounded on a general statute authorizing the inclusion of optional provisions in the charter.

[75] Renn v. United States Cement Co., 36 Ind. App. 149, 73 N. E. 269 (1905); Sherman Center Town Co. v. Morris, 43 Kan. 292, 23 Pac. 569 (1890).

[76] PA. BUS. CORP. L. §402 (1951).

[77] *Compare* PA. BUS. CORP. L. §402 (1951) (fixing a statutory quorum for directors' meetings but

Even in jurisdictions in which the inclusion in the charter of all veto provisions necessary for desired control is clearly authorized, it may still be advantageous to repeat the provisions in the by-laws. By-laws serve as a guide for directors and officers in the conduct of corporate activities; consequently, veto provisions placed there are constantly before the attention of the directors and officers.

VII

PRECAUTIONS THAT STRENGTHENS VETO PROVISIONS

A. Limitation of Veto to Area of Business Need

As a general proposition, the power to veto should be limited to those corporate activities over which a veto is needed to protect legitimate business interests. In most situations, the conferring of a blanket power to veto any or all corporate acts is inadvisable because the existence of that power enhances the chance of deadlock and corporate paralysis. Further, there is probably a greater risk that the courts will invalidate a general veto over all shareholder or director action than a veto over a particular act or over a limited number of specified acts.[78] This increased risk of invalidity is attributable in the final analysis to the possibility that courts will take a dark view of the business wisdom of blanket powers of veto and (rightly or wrongly) will let that business judgment influence their decisions on the validity of the veto provisions.

Whenever a charter or by-law provision is intended to provide a veto only over particular corporate acts, care should be taken that the limited nature of the veto is clearly expressed. Courts cannot be depended on to interpret the provisions so as to restrict their applicability to corporate acts legally subject to veto.[79]

B. OBTAINING UNANIMOUS CONSENT TO ESTABLISHMENT OF VETO

A power of veto usually should not be provided unless all the participants agree to it at the time of its creation. Great caution must be exercised in departing from customary corporate practices, and this is particularly true if some of the participants oppose the departure. At the time a corporation is being formed, the participants as a part of their business bargain usually reach agreement on the pattern of control. If a veto is not agreed on at that time, it is doubtful that the charter or by-laws should be amended thereafter to insert veto provisions to which minority share-

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authorizing variation of the quorum *in the by-laws*), *with* PA. BUS. CORP. L. §503 (1951) (setting a quorum for shareholders' meetings but authorizing variation of the quorum by provision *in the articles*).

[78] *Compare* Benintendi v. Kenton Hotel, 294 N. Y. 112, 60 N. E. 2d 829 (1945) (holding invalid by-laws requiring unanimity for all shareholder and director action) *with* Ripin v. Atlantic Mercantile Co., 205 N. Y. 442, 98 N. E. 855 (1912) (sustaining a charter provision stating that the number of directors could not be changed except by unanimous consent of the shareholders). The court in the *Benintendi* case expressly stated that the holding there did not mean "that an arrangement would necessarily be invalid, which for particular decisions, would require unanimous consent of all stockholders." 60 N. E. 2d at 831.

[79] In Benintendi v. Kenton Hotel, 294 N. Y. 112, 60 N. E. 2d 829 (1945), a by-law requiring unanimity for shareholder action could possibly have been sustained against the objection that it violated statutory norms specifying the shareholder vote for certain corporate acts, if the courts had construed it as applicable only to corporate acts not specified by statute to require a stated vote. See Note, 48 MICH. L. REV. 875 (1950) and discussion of the *Benintendi* case *supra* page 462.

holders object. The risk that a provision will be declared invalid is probably increased by dissent at the time of its adoption. Some courts may be willing to uphold deviations from the statutory pattern of control that are agreed to by all interested persons on the theory that the shareholders by unanimous consent can do as they please with the corporation provided creditors are not prejudiced, but may not be willing to allow departures from the statutory pattern if there are dissenters.[80]

C. Care in Framing Veto Provisions

A veto provision that will be sustained if worded in one way may be invalidated if couched in different language. This point is illustrated by *Aldridge v. Franco Wyoming Oil Co.*[81] The charter provision before the court in that case stated that "no person shall be elected a director of the Corporation against whom there shall be cast the votes of forty percent (40%) in amount of the outstanding Class A stock." Although the court apparently recognized that the charter could require for shareholder action the approval of greater than a majority of all shares or the approval of a high percentage of a specified class of shares,[82] it invalidated the charter provision under consideration. It interpreted the provision to require two elections for directors, one in which all shareholders voted for the directors of their choice and a second in which the holders of the Class A stock expressed approval or disapproval. According to the court, the provision was "not susceptible to the construction that, to effect the election of a director, the candidate must receive the vote of a majority of the common stock and the vote of more than sixty percentum of the Class A stock."[83] The court then drew a distinction between a "voting right" and a "right to veto," and held that a right to veto "is not within the intendment of the law as it is now written."[84]

The draftsman must also keep in mind that veto provisions are likely to be strictly construed. At least one court has warned that charter provisions departing from majority rule will be given effect only if they are clear, explicit and susceptible of but one reasonable interpretation.[85] Therefore, veto provisions must be couched in language free from any ambiguity. A provision requiring unanimity for shareholder

[80] Of interest is Bechtold v. Coleman Realty Co., 367 Pa. 208, 79 A. 2d 661 (1951), recognizing two classes of by-laws: (1) mere regulations governing the conduct of the internal affairs of the corporation, which may be repealed or amended by majority vote unless a greater vote is specified by the by-laws or by statute, and (2) provisions in the nature of a contract evidently designed to vest property rights, which cannot be repealed or changed without the consent of the parties whose rights are affected. Is corporate control a type of property right which would lead a court to place in the second classification a by-law setting the vote for shareholder or director action, and thus to require unanimous consent for an amendment increasing the vote fixed in the by-law?

[81] 24 Del. Ch. 349, 14 A. 2d 380 (1940).

[82] In view of DEL. CORP. L. §§5(11), 17, a contrary conclusion could hardly have been reached. DEL. CORP. L. §5 in listing what the certificate of incorporation shall set forth, expressly states in paragraph 11 that it may contain "provisions requiring for any corporate action the vote of a larger proportion of the stock or any class thereof than is required by this Chapter." See also Sellers v. Joseph Bancroft & Sons Co., 23 Del. Ch. 13, 2 A. 2d 108 (1938), 17 A. 2d 831 (Del. Ch. 1941). These authorities, however, were not referred to in the *Aldridge* case.

[83] 14 A. 2d at 381.

[84] *Ibid.*

[85] Standard Power & Light Corp. v. Investment Associates, 51 A. 2d 572, 576 (Del. Sup. Ct. 1947).

action, for instance, should be so worded that there can be no question that approval of holders of all shares outstanding is necessary, not just approval of shares present or represented at a shareholders' meeting.[86]

D. Using High Vote Requirements in Preference to Requirements of Unanimity

A provision requiring unanimity for shareholder or director action is perhaps a little less likely to be sustained than is a high vote requirement.[87] Some statutory provisions authorizing increases in the voting requirements fixed by statute for shareholder action do so in terms that can be construed as excluding requirements of unanimity. As has been mentioned,[88] some statutes authorize the use in the charter of provisions fixing the vote necessary for shareholder action at "a greater proportion of the shares" than is otherwise required by law. This language provides a convenient peg on which to hang a decision invalidating a requirement of unanimity. A Delaware court has suggested that a provision requiring unanimity for shareholder action may be invalid[89] under the Delaware statute, which states that the charter may include "provisions requiring for any corporate action the vote of a larger proportion of the stock or any class thereof" than is otherwise fixed by the statute.[90] In some situations, therefore, it may be advisable to use a percentage requirement rather than a requirement of unanimity even though the favorable vote required for action must be set at an unusually high percentage in order to provide the veto. In other words, if a power of veto is to be given to a shareholder owning 11 per cent of the stock, it may be better to require for shareholder action concurrence of holders of 90 per cent of the shares rather than unanimity.[91] Whenever a high vote requirement (as distinguished from a requirement of unanimity) is used, however, safeguards must be set up against the issuance of additional shares that will decrease the proportionate holdings of shareholders having a power of veto.[92]

E. Reference to Veto Provisions on Share Certificates

Appropriate reference to veto provisions should be made on each share certificate. The object of this of course is to preclude purchasers of shares from claiming that they were unaware of the veto provisions at the time they bought their shares and

[86] See Investment Associates v. Standard Power and Light Corp., 29 Del. Ch. 225, 48 A. 2d 501 (1946), *aff'd*, 51 A. 2d 572 (Del. Sup. Ct. 1947).

[87] In Kronenberg v. Sullivan County Steam Laundry Co., 91 N. Y. S. 2d 144 (Sup. Ct., Sullivan Co. 1949), the court distinguished Benintendi v. Kenton Hotel, 294 N. Y. 112, 60 N. E. 2d 829 (1945), discussed *supra* page 462, and sustained a clause in the certificate of incorporation requiring an affirmative 85 per cent vote for shareholder action. As each shareholder held at least 20 per cent of the stock, the clause in effect required unanimity.

[88] See *supra* page 464, especially note 70.

[89] See "reservation" in Sellers v. Joseph Bancroft & Sons Co., 23 Del. Ch. 13, 26, 2 A. 2d 108, 114 (1938). Compare discussion in Investment Associates v. Standard Power and Light Corp., 29 Del. Ch. 225, 48 A. 2d 501, 506 (1946), *aff'd*, 51 A. 2d 572 (Del. Sup. Ct. 1947).

[90] DEL. CORP. L. §5(11).

[91] See OHIO BAR ASSOCIATION CORPORATION COMMITTEE REPORT 101 (December 28, 1926), indicating that a requirement of a 90 per cent vote for shareholder action is valid under the Ohio statute, but not mentioning a requirement of unanimity.

[92] See *infra* page 470.

that therefore they should not be bound by the unusual control pattern established by those provisions.

The New York stock corporation law[93] expressly provides that whenever a corporation's certificate of incorporation contains a provision increasing quorum or voting requirements for shareholders' or directors' meetings, "notice of the existence of such provision shall appear plainly on the face or back of every certificate of stock." Although this precise question does not appear to be covered by statute in other jurisdictions, the statutes in most states do contain a number of provisions which taken together may lead the courts to refuse to give effect, at least as against purchasers without notice, to unusual charter or by-law provisions that are not referred to on the certificates of stock.[94]

At any rate, the cautious lawyer will make certain that the veto provisions are referred to on the share certificates. Whenever possible, those provisions should be set forth verbatim on the certificates. If the provisions are too lengthy to be reproduced in full, they should be summarized or paraphrased on the certificates and a clear reference made to the charter or other document containing them.

F. Guarding Against Repeal or Circumvention of Veto Provisions

After the draftsman has decided what veto provisions to use in the articles and by-laws, he must give careful thought to safeguarding those provisions against repeal, and against circumvention by manipulation of majority interests.

Modern corporation statutes authorize charter amendments by specified shareholder vote; some permit amendment by the vote of holders of a simple majority of the shares with voting power. Similarly, by-laws often can be amended or repealed by a simple majority vote of shareholders or of directors. Thus, veto provisions in the articles or by-laws must be protected against the power of amendment and repeal ordinarily possessed by majority interests. Otherwise, the veto can be thwarted by a two-step process: first, amendment or repeal of the veto provisions; second, passage of a resolution by the shareholders or directors, as the case may be, authorizing the action which before the amendment would have been subject to veto.[95] In most jurisdictions, the remedy is to insert in the charter a clause requiring unanimity or a high vote for amendment or repeal of the charter pro-

[93] N. Y. STK. CORP. L. §65.

[94] Illustrative are the following statutory provisions: PA. BUS. CORP. L. §9 (1951) (no person shall be charged with constructive notice of the articles); PA. BUS. CORP. L. §305 (1951) (by-laws shall not affect dealings with outsiders who do not have actual knowledge of them); Uniform Stock Transfer Act §15 (no lien or restriction upon transfer unless indicated on certificate); WIS. BUS. CORP. L. §180.18(2) (1951) (share certificates of corporations with more than one class of shares shall state "the designations, preferences, limitations, and relative rights" of the shares of each class). In spite of these statutes, some cases have given effect to restrictions not appearing on the certificates as against transferees with notice. Doss v. Yingling, 95 Ind. App. 494, 172 N. E. 801 (1930); Trefethen v. Amazeen, 93 N. H. 110, 36 A. 2d 266 (1944); Baumohl v. Goldstein, 95 N. J. Eq. 597, 124 Atl. 118 (Ch. 1924).

[95] See Aldridge v. Franco Wyoming Oil Co., 24 Del. Ch. 126, 7 A. 2d 753 (1939), *aff'd*, 24 Del. 349, 14 A. 2d 380 (1940); Warren v. 536 Broad Street Corp., 4 N. J. Super. 584, 68 A. 2d 175 (1949), *aff'd*, 6 N. J. Super. 170, 70 A. 2d 782 (1950); Markovitz v. Markovitz, 336 Pa. 122, 8 A. 2d 36 (1939). But see Bechtold v. Coleman Realty Co., 367 Pa. 208, 79 A. 2d 661 (1951).

visions establishing a veto; and to insert in the charter, in the by-laws, or in both instruments,[96] clauses requiring a unanimous or high vote for the modification or repeal of veto provisions in the by-laws.[97]

Most corporation statutes permit unanimity or a high percentage vote to be required for amendments of charter or by-laws.[98] In a few jurisdictions, however, doubt exists whether a clause which sets the vote for charter or by-law amendments higher than the figure fixed by statute would be sustained; some statutory provisions specifying the vote for charter or by-law amendments are couched in language that can be interpreted as mandatory.[99] In those jurisdictions, perhaps veto provisions in the charter and by-laws can be protected against amendment by an agreement between the company and its shareholders not to amend.[100]

A power of veto may also be lost through merger or consolidation; or shareholders attempting to exercise a veto may be "frozen out" by the dissolution of the corporation and the formation of a new corporation without the dissenters or by the transfer of all corporate assets to another enterprise.[101] Therefore, approval of all or of a high perecentage of shareholders should normally be required for such fundamental corporate acts as a merger, consolidation, dissolution or the transfer of all corporate assets.

Veto provisions based on a high percentage vote of shareholders must be protected from circumvention through the issuance of additional shares. Otherwise, majority interest may be able to deprive a minority shareholder of his power to veto simply by increasing the number of outstanding shares until his holdings are less than the fraction of outstanding shares required for a veto. Frustration of the veto by that procedure can usually be avoided by the insertion of appropriate provisions in the charter, *e.g.*, clauses providing that treasury shares and authorized but unissued stock can be issued only with the approval of holders of a specified pro-

[96] Provisions governing the amendment of by-laws often may be placed in either the charter or by-laws. Whenever the law permits, the provisions should be inserted in both. See *supra* page 465.

[97] Of course special provisions of this kind are not necessary if an effective veto has been given over all amendments of charter and by-laws. In most states, unanimity or a high vote apparently can be required for amendment of some charter and by-law provisions and a lesser vote for amendment of other provisions.

[98] See *e.g.*, DEL. REV. CODE c. 65, §2037(11) (1935); N. Y. STK. CORP. L. §37; PA. BUS. CORP. L. §§304, 805 (1951); UNIF. BUS. CORP. ACT §38 (II, III). Even Benintendi v. Kenton Hotel, 294 N. Y. 112, 60 N. E. 2d 829 (1945), which declared invalid a number of veto provisions in the by-laws, sustained a by-law requirement of unanimous approval of the shareholders for amendment to the by-laws. But see "reservation" in Sellers v. Joseph Bancroft & Sons Co., 23 Del. Ch. 13, 26, 2 A. 2d 108, 114 (Ch. 1938), indicating that in Delaware a requirement of a hundred per cent vote for charter amendment may be invalid.

[99] See strong dictum in Warren v. 536 Broad Street Corp., 4 N. J. Super. 584, 68 A. 2d 175, 180 (1949), *aff'd*, 6 N. J. Super. 170, 70 A. 2d 782 (1950), that the two-thirds vote specified in New Jersey amendment procedure is mandatory.

[100] In British Murac Syndicate, Ltd. v. Alperton Rubber Co., Ltd., [1915] 2 Ch. 186, a company was restrained from violating a contract not to alter its articles of association, the contract having been entered into by the company and a syndicate holding some of its stock. But see views expressed in Aldridge v. Franco Wyoming Oil Co., 24 Del. Ch. 126, 7 A. 2d 753 (1939), *aff'd* 24 Del. 349, 14 A. 2d 380 (1940), on alleged oral agreement by shareholders not to amend charter.

[101] See Kavanaugh v. Kavanaugh Knitting Co., 226 N. Y. 185, 123 N. E. 148 (1919).

portion of the shares outstanding, clauses requiring a unanimous or high shareholder vote to increase the amount of authorized stock, clauses assuring shareholders a preemptive right in new issues of shares,[102] and combinations of these.

Similarly, veto provisions requiring a high percentage vote for action by the directors may be nullified by an increase in the number of directors.[103] The risk can usually be avoided by fixing the number of directors in the charter or by-laws, and requiring a high shareholder vote to increase the size of the board.[104] A shareholder with a veto must also be protected against the possibility of losing his veto over matters within the province of the directors through the death or incapacity of the director representing his interests. The desired result can usually be achieved by stating in the charter or by-laws that the board cannot act until a vacancy has been filled, and requiring unanimous shareholder approval to fill the vacancy. In some situations, it may be possible to give the shareholder power to fill a vacancy created by the death of his representative on the board.

Finally, thought must be given to the possibility that corporate officers and agents may act beyond their authority and bind the corporation to outsiders.[105] The safeguard against that danger is to appoint reliable officials and require them to furnish adequate bonds.[106]

VIII

CONCLUSION

Lawyers have too seldom taken advantage of the flexibility permitted by modern corporation statutes to mold the corporate device to the needs of closely held enterprises and to the desires expressed by the participants in their business bargains. Those needs and desires can frequently be met by the use of the special charter and by-law provisions discussed in this paper.

Although these veto provisions are exceedingly useful tools in fashioning management patterns for closely held corporations, the limitations and disadvantages of veto provisions must not be overlooked. In the first place, they give a veto and no

[102] Preemptive rights alone are not a complete protection to a shareholder of limited means, because at the critical time he may not have funds available to exercise his pre-emptive rights.

[103] The danger that a veto arrangement may be circumvented by an increase in the number of directors is illustrated by Odman v. Oleson, 319 Mass. 24, 64 N. E. 2d 439 (1946). See also Christal v. Petry, 275 App. Div. 550, 90 N. Y. S. 2d 620 (1st Dep't 1949), *aff'd mem.*, 301 N. Y. 562, 93 N. E. 2d 450 (1950), holding that the by-laws may not restrict the statutory right of majority shareholders to increase the number of directors, but indicating that a restriction of that kind would be effective if inserted in the certificate of incorporation or if unanimously approved in writing by the shareholders.

[104] But see Christal v. Petry, 275 App. Div. 550, 90 N. Y. S. 2d 620 (1st Dep't 1949), *aff'd mem.*, 301 N. Y. 562, 93 N. E. 2d 450 (1950), holding that by-law provision requiring approval of 75 per cent of the voting stock to increase the number of directors was void as inconsistent with a statute providing that the number of directors may be increased by the holders of a majority of the outstanding shares.

[105] In most states, limitations on the authority of corporate officers contained in charter and by-law provisions will not bind outsiders who do not have actual notice. See, *e.g.*, PA. BUS. CORP. L. §§9, 305 (1951).

[106] See Ballard, *Arrangements for Participation in Corporate Management Under the Pennsylvania Business Corporation Law*, 25 TEMP. L. Q. 131, 154-5 (1951).

more; they do not enable minority shareholders to determine policy affirmatively and to go forward with the execution of that policy. Secondly, they deprive the corporation of flexibility which it may need to adjust to unexpected business situations. At the time an enterprise is being incorporated, the draftsman cannot foresee changes in policy and methods of operation which may in the future become advantageous. Finally, veto provisions may place one or two shareholders in a position to extort (as a condition of approval of beneficial corporate action) unfair concessions from the other shareholders. The use of veto provisions therefore involves a problem of balancing the safeguards necessary to protect the interests of minority shareholders against the freedom of action that is beneficial to the corporation and the shareholders as a group.

LIMITED LIABILITY WITH ONE-MAN COMPANIES AND SUBSIDIARY CORPORATIONS

Bernard F. Cataldo*

Limited liability, usually regarded as the most significant feature of corporate enterprise, has received extravagant praise. Among those who have paid verbal homage to the concept of limited liability are two former university presidents who cut a large figure in the intellectual manners of the nation during the last half century. President Eliot of Harvard regarded limited liability as "the corporation's most precious characteristic" and "by far the most effective legal invention . . . made in the nineteenth century."[1] President Nicholas Murray Butler of Columbia made the pronouncement in 1911: "I weigh my words when I say that in my judgment the limited liability corporation is the greatest single discovery of modern times. . . . Even steam and electricity are far less important than the limited liability corporation, and they would be reduced to comparative impotence without it."[2]

Our courts have rested—unnecessarily, it is believed[3]—the concept of limited liability on the legal entity theory. This theory, familiar to every elementary student of corporation law and finance, treats the corporation as a legal *persona* or juristic person constituting an entity in itself separate and distinct from the members. The essence of this theory, stated in stark terms, is that the shareholders own "the corporation" and the latter owns and operates the assets and the business. The questionable[4] but judicially accepted reasoning which regards limited liability as a

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[1] Quoted in Cook, *"Watered Stock"—Commissions—"Blue Sky Laws"—Stock Without Par Value,* 19 Mich. L. Rev. 583 n. 4 (1921).

[2] Quoted in 1 William M. Fletcher, Cyclopedia of the Law of Corporations §21 (1917). See Berl, *The Vanishing Distinction Between Creditors and Stockholders,* 76 U. of Pa. L. Rev. 814, 815 (1928). See also Dodd, *The Evolution of Limited Liability in American Industry: Massachusetts,* 61 Harv. L. Rev. 1351 (1948).

[3] It is not intended to pursue here the old and fruitless quarrel engendered by the "nature of corporateness." The legal entity theory has taken deep root in our legal system and continues to flourish, though as far back as 1884, one writer decried the theory as a vestigial organ requiring excision. Henry O. Taylor, Private Corporations iv (1884). See Machen, *Corporate Personality,* 24 Harv. L. Rev. 347, 352 (1911); Frederick Hallis, Corporate Personality lxi (1930).

[4] See preceding note. See also I. Maurice Wormser, Disregard of the Corporate Fiction and Allied Corporation Problems 29 (1927); Adolf A. Berle, Studies in the Law of Corporate Finance c. 1 (1928); Alexander H. Frey, Cases and Materials on Corporations and Partnerships 51 (1951); Koessler, *The Person in Imagination or Persona Ficta of the Corporation,* 9 La. L. Rev. 435 (1949).

Ballantine, *Separate Entity of Parent and Subsidiary Corporations,* 14 Cal. L. Rev. 12, 20 (1925), states that the entity theory is the "basic theory of corporation law."

A new concept in the field is set forth by Berle, *The Theory of Enterprise Entity,* 47 Col. L. Rev. 343 (1947).

result flowing out of the legal entity theory follows a simple route: The corporation is a separate entity; hence the obligations incurred in the operation of the business are those of the corporation itself, and the shareholders are not personally liable on those obligations.

The extent to which the courts have gone in upholding the doctrine of corporate entity and its companion, limited liability, finds vivid illustration in those cases which concern the closest of close corporations—the one-man company, the family corporation, and the subsidiary corporation.

I

THE ONE-MAN COMPANY AND FAMILY CORPORATION[5]

The evolution of the one-man company and the family corporation is found in the desire to combine limited liability with the complete dominion of the sole proprietorship.[6] A sole proprietor, operating a moderate sized business, organizes a corporation to which he surrenders the business and assets. In return he takes all the shares excepting the few necessary to comply with the statutory provisions respecting incorporators and directors. The few shares he does not take are allotted to his relatives or employees, in order to qualify them as incorporators or directors in accordance with the requirements of the corporation statute. Thus, a corporation is created "in legal form," the sole or principal shareholder retains in effect the exclusive control and full dominion he enjoyed as a sole proprietor, and in addition he achieves the desired privilege of limited liability.[7]

It is most doubtful whether the concept of corporate enterprise was ever intended or designed to embrace this institution.[8] Nevertheless the one-man company and the family corporation have become familiar modes of business enterprise and, despite occasional questioning by a court[9] or a writer,[10] have generally received judicial

[5] Fuller, *The Incorporated Individual: A Study of the One-Man Company*, 51 HARV. L. REV. 1373 (1938); Masten, *"One Man Companies" and Their Controlling Shareholders*, 14 CAN. BAR REV. 663 (1936); Note, *One Man Corporations—Scope and Limitations*, 100 U. OF PA. L. REV 853 (1952).

[6] Occasionally there have been other motives for the formation of one-man companies. Some of these other motives have been: a married man's wish to avoid the incidents of dower with respect to certain realty, a person's desire to avoid the operation of a usury statute which applies to individuals but not to corporations, the desire to facilitate the management and sale of property. See Fuller, *supra* note 5, at 1374.

[7] Note, 45 HARV. L. REV. 1084 (1932).

[8] Rutledge, *Significant Trends in Modern Incorporation Statutes*, 22 WASH. U. L. Q. 305 (1937), suggests a study to determine the advisability of having three types of corporation statutes: one for the extensive business, another for the small or moderate sized businesss, another for the one-man company. See Israels, *The Close Corporation and the Law*, 33 CORNELL L. Q. 488 (1948).

Note, *"One Man Corporations"—Scope and Limitations*, 100 U. OF PA. L. REV. 853, 868 (1952): "Inasmuch as the one man corporation can be justified on economic and social grounds, and since it has been recognized by the courts for over half a century, it would seem advisable that the legislatures of the several states follow the lead of Michigan and Iowa and permit one man to form a corporation and eliminate the board of directors. This would simplify the entire problem and dissolve the aura of disrespectabilty and uncertainty which still hovers over the one man corporation."

[9] See Dollar Cleaners & Dyers, Inc. v. MacGregor, 163 Md. 105, 161 Atl. 159 (1932).

[10] Note, 45 HARV. L. REV. 1084, 1089 (1932): "Limited liability—a protection designed to encourage investment in corporations—would seem unnecessary where corporate ownership and control has been concentrated in the hands of one man. An occasional questioning by the courts of the desirability of

sanction and approval. The usual argument advanced by the courts is: Limited liability is a privilege held out by the corporation law of the state; one who organizes a one-man or family corporation, in compliance with the formalities of that law, for the purpose of attaining limited liability in a commercial venture, is merely taking advantage of a privilege conferred by law.[11] One might well question both the logic and the historical realities in this judicially tailored reasoning. What is far more important, however, is that this and similar reasoning indicates clearly a judicial policy to sponsor the one-man company and the family corporation.[12]

A. Contractual Obligations

The fact that all or almost all the shares of a corporation are owned by one individual is not sufficient ground for disregarding corporate personality.[13] This view seems now too settled for dispute.[14] Accordingly the distinction between the corporate property and the individual property of the sole shareholder is carefully preserved for legal purposes.[15] The same is true of the distinction between corporate obligations and the personal obligations of the sole shareholder. Corporate creditors

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the one man corporation is indicative of this point of view." See I. MAURICE WORMSER, FRANKENSTEIN INCORPORATED 95 ff. (1931).

[11] Elenkrieg v. Siebrecht, 238 N. Y. 254, 144 N. E. 519 (1924); Salomon v. Saloman & Co., Ltd. [1897] A. C. 22. See Inland Revenue Commissioners v. Sansom, [1921] 2 K. B. 492, 500, 125 L. T. R. 37.

[12] In Inland Revenue Commissioners v. Sansom, [1921] 2 K. B. 492, 514, 125 L. T. R. 37, Younger, L. J., said: "Now, speaking for myself, I do in the light of these considerations, deprecate in connection with what are called one-man companies, the too indiscriminate use of such words as simulacrum, sham, or cloak—the terms found in this case—or indeed any other term of polite invective. Not only do these companies exist under the sanction, even with the encouragement of the Legislature, but I have no reason whatever to doubt that the great majority of them are as bona fide and genuine as in a business sense they are convenient and suitable media for the provision and application of capital to industry.

No doubt there are amongst such companies, as amongst any other kind of association, black sheep; but in my judgment such terms of reproach as I have alluded to should be strictly reserved for those of them and of their directors who are shown to deserve condemnation, and I am quite satisfied that the indiscriminate use of such terms has, not infrequently, led to results which are unfortunate and unjust, and in my judgment this is no case for their use."

[13] Macan v. Scandinavia Belting Co., 264 Pa. 384, 391, 107 Atl. 750, 752 (1919): "A corporation has a separate entity or existence, irrespective of the persons who own its stock, and this rule is not altered by the fact that the greater portion or even the entire issue of stock happens to be held by one person." See Star Brewing Co. v. Flynn, 237 Mass. 213, 129 N. E. 438 (1921); Eichelberger v. Arlington Building, Inc., 280 Fed. 997, 999 (D. C. Cir. 1922).

[14] *In re* John Koke Co., 38 F. 2d 232, 233 (9th Cir. 1930): "The rule is quite elementary that a corporation is an entity separate and distinct from its stockholders, with separate and distinct rights and liabilities; and this is true even though a single individual may own all, or nearly all, of the capital stock."

Commerce Trust Co. v. Woodbury, 77 F. 2d 478, 487 (8th Cir. 1935): "Few questions of law are better settled than that a corporation is ordinarily a wholly separate entity from its stockholders, whether they be one or more." See Corley v. Cozart, 115 F. 2d 119, 121 (5th Cir. 1940).

[15] The leading American decisions are Button v. Hoffman, 61 Wis. 20, 20 N. W. 667 (1884), and Parker v. Bethel Hotel Co., 96 Tenn. 252, 34 S. W. 209 (1896). In the *Button* case the sole shareholder was unsuccessful in an action of replevin brought in his individual name to recover corporate assets from one wrongfully in possession of them. See also Moroney v. Moroney, 286 S. W. 167 (Tex. Comm. App. 1926). In the *Parker* case the court held inoperative the sole shareholder's attempt to alienate corporate property in his individual name. *Accord:* Corley v. Cozart, 115 F. 2d 119 (5th Cir. 1940). *Cf.* Earp v. Schmitz, 334 Ill. App. 382, 79 N. E. 2d 637 (1948). See WALTER H. ANDERSON, LIMITATIONS OF CORPORATE ENTITY 97 (1931).

cannot obtain satisfaction from the sole shareholder and his individual property;[16] creditors of the sole shareholder cannot obtain satisfaction from the corporation and corporate assets.[17] The same general principle governs in the matter of set-off.[18] For example, in a case where an insolvent bank held the deposit of a corporation and the individual note of that corporation's sole shareholder, the latter was not allowed to set off the amount of the deposit against his liability on the note.[19]

This distinction between corporate and individual obligations and creditors, and the ensuing limited liability of the sole shareholder, may be supported on extra-legal and purely pragmatic grounds. The obligee of a contractual obligation has an opportunity of knowing and choosing his obligor. He should know with whom he is dealing and should be bound by his choice. If insolvency overtakes the sole shareholder, or the corporation, or both, it is necessary to weigh the respective positions of those who dealt with the business on a corporate basis and those who dealt with the sole shareholder as an individual. The equities of the former are no greater than those of the latter. The former will be limited to the corporate assets; the latter, to the individual assets. By this marshalling, the equal equities of both groups are preserved, in the usual and ordinary case.

As a simple example, suppose a draft names a corporate drawee. The draft is accepted by the drawee in the corporate name and is later discounted by a bank. It turns out that the acceptor is a one-man company. The bank may not hold that company's sole shareholder liable on the instrument, even though the company becomes insolvent and is unable to pay.[20] The acceptance appearing on the instrument was in a corporate name and the bank had an opportunity to determine the real identity of the acceptor before it discounted the draft. The bank receives all it bargained for when it is given a legal remedy on the instrument against the corporation. If the bank and other corporate creditors were permitted to hold the sole shareholder liable, the latter's individual assets would be depleted at the possible expense of his personal creditors who dealt with him as an individual and should have priority in his personal assets.

It is a fair guess that courts are motivated by these considerations,[21] although they

[16] Louisville Banking Co. v. Eisenman, 94 Ky. 83, 21 S. W. 531 (1893). See ROBERT S. STEVENS, HANDBOOK ON THE LAW OF PRIVATE CORPORATIONS 75 (2d ed. 1949): "When one extends credit to a corporation, he may not, upon the insolvency of the corporation, claim satisfaction out of the individual property of the sole shareholder. . . ." See EDWARD H. WARREN, SELECT CASES AND OTHER AUTHORITIES ON THE LAW OF PRIVATE CORPORATIONS 89 note (1916, Reprint of 1930). *Cf. Re* O'Brien, 40 F. 2d 554 (D. Minn. 1930).

[17] *In re* John Koke Co., 38 F. 2d 232 (9th Cir. 1930); Geary v. Cain, 79 Utah 268, 9 P. 2d 396 (1932). See Star Brewing Co. v. Flynn, 237 Mass. 213, 129 N. E. 438 (1921); Tinnin v. Wilkirson, 58 S. W. 2d 69 (Tex. Comm. App. 1933).

[18] Looney v. Thorpe Bros., 277 Fed. 367 (8th Cir. 1921); Gallagher v. Germania Brewing Co., 53 Minn. 214, 54 N. W. 1115 (1893). But see U. S. Gypsum Co. v. Mackey Wall Plaster Co., 60 Mont. 132, 199 Pac. 249 (1921). *Cf.* Gay v. Hudson River Electric Power Co., 187 Fed. 12 (2d Cir. 1911).

[19] State *ex rel.* Sorensen v. Weston Bank, 125 Neb. 612, 251 N. W. 164 (1933). *Accord:* Dennis v. Smith, 49 S. W. 2d 909 (Tex. Civ. App. 1932).

[20] Louisville Banking Co. v. Eisenman, 94 Ky. 83, 21 S. W. 531 (1893).

[21] See the excerpt from Lord Herschell's opinion in Salomon v. Saloman & Co., Ltd. [1897] A. C. 22, quoted in note 31, *infra*. A recent case which seems to push this attitude too far, in view of the

generally prefer to place their decisions on the simple base of the legal entity theory. A case which is unusual in this regard, because the "election" factor appears in bold relief and the court mentions the conflicting equities of rival groups of creditors, is In re *John Koke Co.*,[22] decided in 1930 by the United States Court of Appeals for the Ninth Circuit. Here money was borrowed personally by the sole shareholder of a corporation for the declared purpose of paying off corporate debts. Upon the subsequent bankruptcy of both the shareholder and the corporation, the lender sought to share as a corporate creditor with a claim against the corporate assets. The court denied his claim and said that since he knew the purpose of the loan he was "bound by the election thus made, in view of the possible intervening rights of other creditors."

B. Tort Liability

The foregoing reasoning would not be applicable to tort liability. Needless to say, in the ordinary case the victim of a tort does not rely on, deal with, or choose his tortfeasor. It is conceivable, therefore, that courts might distinguish in this connection between contractual obligations and tort liability. They might refuse to sponsor limited liability for the sole shareholder in the one-man company with respect to "strangers" injured by a tort committed in the execution of the corporate business, although they have sustained limited liability for such a shareholder with respect to contractual obligations. The courts have, however, neither drawn nor honored this distinction. The sole or principal shareholder has been held not to be personally liable to a party injured by the negligent act of a corporate employee,[23] or by the negligent maintenance of the corporate property.[24] In the leading case to this effect, decided by one of our most respected tribunals, the plaintiff was injured by reason of the faulty construction and negligent maintenance of a building, which was owned and operated by a realty company and had been leased by it to various tenants. The New York Court of Appeals held that the plaintiff, an employee of one of the tenants, had no right of action against the principal shareholder of the realty company. The court exclaimed:[25]

> The fact that it is a family corporation, so to speak, is nothing suspicious or illegal. Innumerable are the corporations wherein all the stock is owned by a few members of one family. The fact that one man may own all but a few shares of the stock, and be

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particular circumstances there disclosed, is Westervelt's Sons v. Regency, Inc., 63 A. 2d 818 (N. J. Super. Ch. 1948), *aff'd*, 3 N. J. Super. 173, 65 A. 2d 776 (1949). Here the court said (p. 820): "The plaintiff contracted with Regency, Inc. Presumably plaintiff intended to look to the assets of Regency, Inc. for the payment of its claim. Had plaintiff intended to charge the van Doorns personally it would have insisted upon having them join in the contract. All the plaintiff can ask is that the assets of Regency, Inc. shall be made available for the payment of its claim. The fact that there are other claims and that bankruptcy has intervened does not alter the situation."

[22] 38 F. 2d 232, 233 (9th Cir. 1930).

[23] Sayers v. Navillus Oil Co., 41 S. W. 2d 506 (Tex. Civ. App. 1931); Hayhurst v. Boyd, 50 Idaho 752, 300 Pac. 895 (1931). *Cf.* Cooper v. Industrial Commission, 74 Ariz. 351, 249 P. 2d 142 (1952); Price v. Old Label Liquor Co., 23 N. J. Super. 165, 92 A. 2d 806 (1952).

[24] Elenkrieg v. Siebrecht, 238 N. Y. 254, 144 N. E. 519 (1924).

[25] Elenkrieg v. Siebrecht, 238 N. Y. at 260, 262, 144 N. E. at 521.

in fact the dominant and controlling factor or the only active manager of the corporation, is no evidence in and of itself that the corporation does not exist as a person in the eyes of the law, actually owning, operating, and controlling property. . . . Many a man incorporates his business or his property and is the dominant and controlling feature of the corporation. He may do so for the very purpose of escaping personal liability, and he may do so as a cover if in fact the corporation really exists—is doing business as permitted by the laws of this state or the state of its incorporation; in other words, is a person recognized by the law.

In the cases found dealing with this problem the tort concerned was negligence. There is a question whether the same rule should govern respecting tortious misconduct which is intentional or deliberate, such as the tort of assault or false imprisonment committed in the execution of the corporate business by an employee or by the sole shareholder himself. Conceivably the sole shareholder might be denied the privilege of limited liability when he has himself committed a tort of this character within the scope of the corporate business.[26] It is likely, though, that the courts will, without distinction, apply the broad standard of limited liability to both classes of torts, just as they have, without distinction, upheld limited liability for both contractual obligations and tort liability for negligence.[27]

C. The Sole Shareholder as a Corporate Creditor

It is natural for the courts, having proceeded to this point, to hold that the sole shareholder may lend money to the business and share as a corporate creditor upon the subsequent insolvency of the venture.[28] Indeed, the sole or principal shareholder may become a secured corporate creditor and thus acquire priority over the unsecured corporate creditors. This position was sustained by the eminent authority of the English House of Lords a half century ago in *Salomon v. Salomon & Co., Ltd.*,[29] a decision which haunts every discussion of corporate entity and limited liability. The essential facts of this celebrated case were that Salomon, a prosperous sole proprietor in the boot and shoe business, desirous of achieving limited liability, formed a corporation with an authorized share capital of 40,000 pounds (40,000 shares

[26] A decision which seems to sustain this position, without any explanation or discussion of the matter, is found in the case of Jackson v. Kirschman, 175 So. 105 (La. App. 1937).

[27] In Geary v. Cain, 79 Utah 268, 9 P. 2d 396 (1932), the plaintiff was assaulted by *C* and obtained judgment against *C*. He sought to reach, in satisfaction of this judgment, the assets of a family corporation of which *C* was actually the sole shareholder, but did not succeed. At first glance it seems as if a new and startling type of spendthrift trust is being sanctioned whereby a hothead may transfer his assets to a corporation and thus place them beyond the reach of those whom he intentionally harms in the future. The case is hardly so ominous and its significance seems to be primarily procedural. *C's* shares are his personal property, and the plaintiff, like any other creditor of *C*, may reach those shares in satisfaction of the judgment entered against C. In this way the plaintiff will reach *C*'s net worth in the corporate venture, without injury to the corporate creditors. The equities of the corporate creditors, who have priority in the corporate assets, and of the plaintiff, who has a claim against the sole shareholder as an individual, are kept in balance.

[28] Wheeler v. Smith, 30 F. 2d 59, 61 (9th Cir. 1929): "While the claim of a sole stockholder against a bankrupt corporation should be scrutinized with care, it is not the law that such a claim should be rejected merely because the claimant is such sole stockholder." See Peckett v. Wood, 234 Fed. 833 (3d Cir. 1916); Gardner v. Rutherford, 57 Cal. App. 2d 874, 136 P. 2d 48 (1943). *Cf.* Pott v. Schmucker, 84 Md. 535, 36 Atl. 592 (1897).

[29] [1897] A. C. 22.

with a par value of 1 pound each). He surrendered his solvent business at the overvalued figure of 39,000 pounds to the corporation. In return the corporation assumed the obligation of paying off the debts of the old business, amounting to 1000 pounds, and Salomon received 20,001 shares and 100 debentures. The latter had a par value of 100 pounds each and represented a lien on the corporate assets. His wife and five children, who served as the incorporators along with him, were allotted one share each, and no other shares were ever issued. Salomon and two sons constituted the board of directors, and Salomon was appointed chairman of the board and managing director. On the security of his debentures Salomon borrowed from Broderip 5000 pounds, which were paid into the corporate treasury as a loan from Salomon. As part of the transaction, the debentures held by Salomon were cancelled, new debentures in the same amount were issued to Broderip, with the understanding that Salomon was the "beneficial owner" of the new debentures, subject only to Broderip's prior security interest therein to the extent of the loan in question. Business adversity, in the form of strikes in the trade and the government's failure to give the number of orders anticipated, caused the corporation to become insolvent. In liquidation proceedings instituted some fourteen months after incorporation, it was held that: first, Broderip was entitled to full payment of his claim; second, the balance of the assets, about 1000 pounds, should go to Salomon "as beneficial owner of the debentures"; third, the unsecured creditors, with claims amounting to about 8000 pounds, would receive nothing.

Salomon, the bootmaker, and Salomon & Co., Ltd., were distinct and separate persons,[30] the Lords argued, and the fact that he incorporated for the purpose of achieving limited liability was of no moment, since limited liability is a legitimate and permissible object of incorporation, conferred by the corporation law of the realm.[31]

[30] Lord Herschell said (pp. 42-43): "Under these circumstances, I am at a loss to understand what is meant by saying that A. Salomon & Co., Ltd., is but an 'alias' for A. Salomon. It is not another name for the same person; the company is ex hypothesi a distinct legal persona. As little am I able to adopt the view that the company was the agent of Salomon to carry on his business for him. In a popular sense, a company may in every case be said to carry on business for and on behalf of its shareholders; but this certainly does not in point of law constitute the relation of principal and agent between them or render the shareholders liable to indemnify the company against the debts which it incurs."

[31] Lord Herschell declared (pp. 44-45, 46): "It is said that the respondent company is a 'one man' company, and that in this respect it differs from such companies as those to which I have alluded. But it has often happened that a business transferred to a joint stock company has been the property of three or four persons only, and that the other subscribers of the memorandum have been clerks or other persons who possessed little or no interest in the concern. I am unable to see how it can be lawful for three or four or six persons to form a company for the purpose of employing their capital in trading, with the benefit of limited liability, and not for one person to do so, provided, in each case, the requirements of the statute have been complied with and the company has been validly constituted. How does it concern the creditor whether the capital of the company is owned by seven persons in equal shares, with the right to an equal share of the profits, or whether it is almost entirely owned by one person, who practically takes the whole of the profits? The creditor has notice that he is dealing with a company the liability of the members of which is limited, and the register of shareholders informs him how the shares are held, and that they are substantially in the hands of one person, if this be the fact. . . . But we have to interpret the law, not to make it; and it must be remembered that no one need trust a limited liability company unless he so please, and that before he does so he can ascertain, if he so please, what is the capital of the company, and how it is held."

Some thirty years later the Maryland court, faced with the same issue, reached a different conclusion and drily remarked: "This court does not think the law contemplates that one may incorporate an established business of his own, continue to own and control it as before, and at the same time, for his personal benefit, put beyond the reach of prospective creditors all the assets of the corporation."[32]

D. Disregard of Corporate Personality

The concept of corporate personality will be sustained only so long as it is invoked and employed for legitimate purposes. Courts will not sanction a perversion of the concept to improper uses and dishonest ends. A perversion is clearly perceived when the notion of corporateness is used as a device to perpetuate fraud, to evade the law, or to escape obligations.[33] In cases of this gender the courts do

[32] Dollar Cleaners & Dyers, Inc. v. MacGregor, 163 Md. 105, 109, 161 Atl. 159, 161 (1932).

Professor Ripley's sentiments were the same. Speaking of the *Salomon* case, he said: "The House of Lords, on the other hand, concluded the matter by holding that, inasmuch as all legal formalities had been duly observed, there was no fraud. Fraud or no fraud, to the lay mind the whole flimsy pretext more than borders on the ridiculous. It rather controverts the famous characterization of Disraeli, that 'the legal mind chiefly displayed itself in illustrating the obvious, explaining the evident, and expatiating on the commonplace.'" WILLIAM Z. RIPLEY, MAIN STREET AND WALL STREET 64-65 (1927).

Complete approval of the *Salomon* case was expressed in Inland Revenue Commissioners v. Sansom, [1921] 2 K. B. 492, 125 L. T. R. 37.

One writer, speaking in 1936, said that "the principle of the Salomon Case stands unimpaired." Masten, *One Man Companies and Their Controlling Shareholders,* 14 CAN. BAR. REV. 663, 671 (1936).

[33] United States v. Milwaukee Refrigerator Transit Co., 142 Fed. 247, 255 (C. C. E. D. Wis. 1905): "If any general rule can be laid down, in the present state of authority, it is that a corporation will be looked upon as a legal entity as a general rule, and until sufficient reason to the contrary appears; but, when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime, the law will regard the corporation as an association of persons." See Eichelberger v. Arlington Building, Inc., 280 Fed. 997, 999 (D. C. Cir. 1922); Kutz Canon Oil & Gas. Co. v. Harr, 56 N. M. 358, 244 P. 2d 522, 527 (1952).

Pacific Can Co. v. Hewes, 95 F. 2d 42, 45 (9th Cir. 1938): "A familiar principle of law has been that a corporation is an entity, distinct in itself. It is true that when resourcefulness of man caused a corporation to be used as a scapegoat for another, courts checked the evil."

Ruberoid Co. v. North Texas Concrete Co., 193 F. 2d 121, 122 (5th Cir. 1951): "The doctrine of separate entity fills a useful purpose in business life, and the courts are hesitant to disregard it unless the facts presented demonstrate some misuse of the corporate privilege or the need of limiting it in order to do justice."

The problem is pursued at length in the article by Horowitz, *Disregarding the Entity of Private Corporations,* 14 WASH. L. REV. 285 (1939), 15 WASH. L. REV. 1 (1940). See also Note, *Piercing the Corporate Veil,* 4 U. OF FLA. L. REV. 352 (1951). A special aspect of this problem, dealing with the corporation as a "person" under the New York usury law, is found in Note, 38 CORNELL L. Q. 93 (1952).

Some of the schemes are so transparent as to leave one incredulous. It is a fair guess, though, that for each scheme which is brought before the courts and judicially unraveled at great expense to the litigant, there are many which do not reach the courts and are successful.

In Great Oak Bldg. Ass'n v. Rosenheim, 341 Pa. 132, 19 A. 2d 95 (1941), the plaintiff held a mortgage on property owned by the defendant, who transferred it to a one-man company created for the purpose with an authorized share capital of $500. Of the 100 shares authorized he took 98, and his wife and daughter each took one. The corporation assumed the obligation to pay off the mortgage and to pay the defendant $500, in return for the transfer of property, and no cash or other assets were paid or exchanged. The defendant continued to collect rents as he had in the past and put them in his personal bank account, except for the amounts necessary to pay the expense of maintaining the property. There were no corporate books and no corporate bank account. The whole purpose of the arrangement was, the defendant conceded, to relieve him of personal liability on the mortgage debt. After the foreclosure of the mortgage by the plaintiff, the latter was obliged to satisfy unpaid taxes on the property. The defendant was held personally liable to reimburse the plaintiff for the amount of the

not permit parties to play hide-and-seek by assuming the dual role of human being, on the one hand, and corporation, on the other. Acts done in corporate form will be considered the individual acts of the members,[34] and acts done by the members will be considered corporate acts.[35]

Though it is undeniable that the notion of corporate personality will be disregarded when invoked to "defeat public convenience, justify wrong, protect fraud, or defend crime," it would be erroneous to assume that this general rule states the limits of judicial action in the matter. There is a marked tendency to disregard corporate personality in those cases where adherence to the concept of corporateness will result in inequity or will prevent a full settlement of the dispute between the

taxes in question. The court said (341 Pa. at 137, 19 A. 2d at 97): "With this principle in mind, the paper mask of the charter, because it is nothing more, will not be permitted to hide the features of the individual behind it."

In Higgins v. Smith, 308 U. S. 473, 475 (1940), a one-man company was formed for the purpose of buying securities from and selling securities to the sole shareholder. The shareholder was not permitted to deduct a loss arising from the sale of securities from him to the corporation. The jury, pursuant to instructions from the court, found that there was not a real transfer "out of Mr. Smith and into something that existed separate and apart from him," but simply "a transfer by Mr. Smith's left hand, being his individual hand, into his right hand, being his corporate hand, so that in truth and fact there was no transfer at all." See Anderson v. Abbott, 321 U. S. 349 (1944).

[34] Claude Neon Lights, Inc. v. Federal Neon Tube Corporation, 52 F. 2d 169 (S. D. N. Y. 1931); Mosher v. Salt River Valley W. U. Ass'n, 39 Ariz. 567, 8 P. 2d 1077 (1932); Veterans Service Club v. Sweeney, 252 S. W. 2d 25 (Ky. App. 1952); Biscayne Realty & Ins. Co. v. Ostend Realty Co., 109 Fla. 1, 148 So. 560 (1933).

In the case last cited, Busch and his wife were engaged in the real estate business. He owned all but a very few shares in a corporation which had no assets, did no business, and was used merely as a medium for taking title to lands purchased by Busch. His practice was to buy land, take title in the corporate name, and then have the title transferred from the corporate name to himself and/or his wife. On one occasion he purchased realty, took title in the corporate name, paid part of the price, and for the balance gave the seller promissory notes executed in the corporate name. Title to the property was then transferred from the corporate name to Busch. The promissory notes were not paid and the seller sued the corporation and obtained judgment against it. Unable to collect the judgment from the corporation, he asked the court to declare Busch personally liable on the notes and to subject Busch's individual assets to payment of the judgment. The court gave the relief sought and said that the corporation was a mere alter ego of Busch, who was in effect conducting an individual business under a trade name. The court declared (109 Fla. at 18, 148 So. at 564): "If the stockholders of a corporation enter into a transaction in their individual and private interests, and utilize the name of the corporation merely as a convenience for the completion of the transaction, where the legal entity as such has no interest in the matter, but the name is used to mislead creditors or perpetuate a fraud upon them, the legal entity in the name of which the transaction was carried will be ignored and the parties held to individual liability." See also Bressman Inc. v. Mosson, 127 Misc. 282, 215 N. Y. Supp. 766 (1st Dep't 1926); Shea v. Leonis, 14 Cal. 2d 666, 96 P. 2d 332 (1939); Natelson v. A. B. L. Holding Co., Inc., 260 N. Y. 233, 183 N. E. 373 (1932), where the court said (260 N. Y. at 238, 183 N. E. at 374) that "liability, divorced from the means of meeting it, was the sole portion of the corporation. . . . This, we think, pushes the theory of dual personality too far."

[35] Norma Mining Co. v. Mackay, 241 Fed. 640 (9th Cir. 1917); Wenban Estate, Inc. v. Hewlett, 193 Cal. 675, 227 Pac. 723 (1924).

The two classical instances are People v. North River Sugar Refining Co., 121 N. Y. 582, 24 N. E. 834 (1890), and State v. Standard Oil Co., 49 Ohio 137, 30 N. E. 279 (1892).

A striking example is the case of the sole or principal shareholder who sets fire to corporate property. Corporate personality is disregarded in order to prevent the shareholder from profiting by his own wrong, and his incendiarism is considered a good defense to a suit brought by the corporation to recover on its fire policy covering the property. Neily Co. v. London & Lancashire Fire Insurance Co., 148 Fed. 683 (3d Cir. 1906). *Accord:* D. I. Felsenthal Co. v. Northern Assurance Co., 284 Ill. 343, 120 N. E. 268 (1918). *Cf.* Firemen's Mutual Insurance Co. v. Aponaug Mfg. Co., 149 F. 2d 359 (5th Cir. 1945).

real parties in interest in a given situation.[36] Under the aegis of this fluid principle a court may move freely in deciding a case on the merits.[37]

These sentiments have special significance with respect to one-man companies and family corporations. Here the sole or principal shareholder, like Janus, represents and constitutes an incorporated venture, on one side, and an individual, on the other side. His complete dominion and superior knowledge carry opportunities for manipulation and maneuvering.[38] Accordingly his privilege of limited liability is conditioned on compliance with two requirements.[39] First, he must conduct the business on a corporate footing and thereby maintain and preserve the separate identity of the venture.[40] Second, he must establish the corporate venture

[36] Thornburgh Construction Co. v. College Heights Development, 244 P. 2d 735 (Cal. App. 1952); D. N. & E. Walter & Co. v. Zuckerman, 214 Cal. 418, 6 P. 2d 251 (1931); Note, 36 YALE L. J. 254. See Wenban Estate, Inc. v. Hewlett, 193 Cal. 675, 696 f., 227 Pac. 723 (1924); Note, 10 MINN. L. REV. 598, 607 (1926). *Cf.* Progress Tailoring Co. v. Federal Trade Commission, 153 F. 2d 103 (7th Cir. 1946).

Metropolitan Holding Co. v. Snyder, 79 F. 2d 263, 266 (8th Cir. 1935): "There has been a growing tendency upon the part of the courts to disregard corporate entity and to treat the stockholders thereof as an association of individuals when the interests of justice are to be served."

[37] For example, see State Trust & Savings Bank v. Hermosa Land & Cattle Co., 30 N. M. 566, 240 Pac. 469 (1925); U. S. Gypsum Co. v. Mackay Wall Plaster Co., 60 Mont. 32, 199 Pac. 249 (1921).

Indeed, the court may feel moved to disregard corporate personality in order to protect the corporate shareholders themselves against inequity. Marchman v. McCoy Hotel Operating Co., 21 S. W. 2d 552 (Tex. Civ. App. 1929), 43 HARV. L. REV. 831 (1930). See U. S. Gypsum Co. v. Mackay Wall Plaster Co., *supra* note 37, just cited above. *Cf.* Crystal Pier Amusement Co. v. Cannan, 219 Cal. 184, 25 P. 2d 839 (1933); Application of Field, 190 F. 2d 268 (Ct. of Cus. and Pat. App. 1951).

The simple truth of the matter is that whether the court will sustain or disregard corporate personality depends upon the policy which the court sponsors in the particular case. Nowhere is this better illustrated than in the cases involving government owned corporations. In these cases corporate personality is sometimes sustained and sometimes disregarded, depending upon the end result considered judicially desirable in the given case. For example, contrast: Sloan Shipyards Corporations v. Emergency Fleet Corporation, 258 U. S. 459 (1921); Emergency Fleet Corporation v. Wood, 258 U. S. 549 (1921); United States v. Walters, 263 U. S. 15 (1923); Clallam County v. United States, 263 U. S. 341 (1923); Southern Pacific Co. v. Defense Supplies Corp., 64 F. Supp. 605 (N. D. Cal. 1946), noted in 20 So. CAL. L. REV. 293 (1947).

Another striking example, concerning one-man companies, is found in two cases decided by the same court in the same year. These are: Erkenbracher v. Grant, 187 Cal. 7, 200 Pac. 641 (1921), and Minifie v. Rowley, 187 Cal. 481, 202 Pac. 673 (1921). In both cases the court was obliged to "avoid" the statute of limitations in order to reach a just result. In the first case, it achieved this result by holding that the one-man company concerned was an entity disinct from the sole shareholder. In the second case, it achieved this result by holding that corporate personality should be disregarded and by treating the sole shareholder and the corporation as one party. Accord: Brooklyn Trust Co. v. Povdin, 14 N. J. Super. 470, 82 A. 2d 485 (1951).

These and similar miscellaneous cases concerning one-man companies are discussed in Note, *One Man Corporations—Scope and Limitations,* 100 U. OF PA. L. REV. 853, 865, 866 (1952). Of these cases the writer says: "It is apparent that each case is being decided on its particular facts. The only standard is a just and equitable result. It is impossible to formulate a more definite test."

[38] "In all the experience of the law, there has never been a more prolific breeder of fraud than the one-man corporation. It is a favorite device for the escape of personal liability." The trial court, as quoted by Mr. Justice Douglas in Pepper v. Litton, 308 U. S. 295, 313, note (1939).

[39] Note, 45 HARV. L. REV. 1084, 1089 (1932): "Opposed to the utility of the corporate device, however, is its peculiar susceptibility to fraudulent use when made available to an individual. The peculiar opportunity for manipulation of assets and the superior knowledge of the sole shareholder might make it desirable to require that when he claims limited liability, he must show affirmatively that the corporation was adequately financed and that its financial identity was kept unimpaired."

[40] *In re* Looschen Piano Case Co., 261 Fed. 93 (D. N. J. 1919), a sole proprietor, engaged in the business of manufacturing piano cases, formed two one-man companies. To the first he transferred the

on an adequate financial basis.[41]

For instance, suppose the business is carried on as if it were the individual business of the sole shareholder, who makes contracts for the business in his own name, keeps no individual bank account, and, without separate accounting, places individual funds and income in the business and draws money from the business for personal needs at his pleasure. Upon the subsequent insolvency of the business he will not be permitted to share as a corporate creditor for sums he advanced to the business as loans. Since he failed to draw a line between his individual and the corporate affairs, the court refuses to draw the line for him and lets him stand where he placed himself.[42] Likewise, under such circumstances the sole shareholder will be personally liable for obligations incurred in the execution of the business.[43]

The same results follow when the corporation is inadequately capitalized.[44]

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realty, to the second he transferred the good will and remaining assets, of the business. No corporate formalities were observed, no separate records were maintained for the two companies, the affairs of both companies were completely "intermingled," and the entire venture was operated, as heretofore, as a sole proprietorship. Upon the bankruptcy of the second company, the trustee was held entitled to the assets of the first company, as part of the bankrupt estate. The court curtly observed (p. 97): "The law will regard two corporations as separate and distinct entities, when they are so regarded and so treated in their operation by their directors or management."

[41] Pepper v. Litton, 308 U. S. 295, 308-310 (1939): "Thus, salary claims of officers, directors, and stockholders in the bankruptcy of 'one-man' or family corporations have been disallowed or subordinated where the courts have been satisfied that allowance of the claims would not be fair or equitable to other creditors. And that result may be reached even though the salary claim has been reduced to judgment. . . . It is also reached where on the facts the bankrupt has been used merely as a corporate pocket of the dominant stockholder, who, with disregard of the substance or form of corporate management, has treated its affairs as his own. And so-called loans or advances by the dominant or controlling stockholder will be subordinated to claims of other creditors and thus treated in effect as capital contributions by the stockholder not only in the foregoing types of situations but also where the paid-in capital is purely nominal, the capital necessary for the scope and magnitude of the operations of the company being furnished by the stockholder as a loan." See *Re* Merrick Dairy Co., 249 Wis. 295, 24 N. W. 2d 679 (1946) (salary claims of three dominant shareholder-directors subordinated to claims of general corporate creditors).

[42] Gordon v. Baton Rouge Stores Co., Inc., 168 La. 248, 121 So. 759 (1929). *Accord: Re* Burntside Lodge, Inc., 7 F. Supp. 785 (D. Minn. 1934); Edward Finch Co. v. Robie, 12 F. 2d 360, 362 (8th Cir. 1926): "The corporation and the bankrupt were one and the same. Their affairs were so intermingled and commingled that no individuality or corporate entity is discernible." See HENRY W. BALLENTINE, PRIVATE CORPORATIONS 294 (2d ed. 1946). *Cf.* Louisville & Nashville R. R. v. Nield, 186 Ky. 17, 23, 216 S. W. 62, 65 (1919), in which the defendant, according to the court, performed the staggering feat of "swallowing the corporation whole" and thereby became liable for its debts. See Pepper v. Litton, 308 U. S. 295 (1939).

[43] Wittman v. Whittingham, 85 Cal. App. 140, 259 Pac. 63 (1927); Tynes v. Shore, 185 S. E. 845 (W. Va. 1936); Western Securities Co. v. Spiro, 62 Utah 623, 211 Pac. 856 (1923). *Cf.* Lobby Display Frame Corp. v. Steinberg, 114 N. Y. S. 2d 917, 115 N. Y. S. 2d 859, 117 N. Y. S. 2d 330 (1952).

Fuller, *The Incorporated Individual: A Study of the One-Man Company*, 51 HARV. L. REV. 1373, 1381 (1938), argues that the sole shareholder should not be liable merely because he failed "to observe a nice distinction between his dual capacities." The wisdom of this position is open to question. He then says that in the decided cases in which the claimant succeeded the sole shareholder was held personally liable only because of additional features, such as a showing of inadequate corporate capital or a showing that the claimant was misled. This generalization does not seem warranted by the cases.

[44] Arnold v. Phillips, 117 F. 2d 497 (5th Cir. 1941), *cert. denied*, 313 U. S. 583 (1941); Dixie Coal Mining Co. v. Williams, 221 Ala. 331, 128 So. 799 (1930) (sole shareholder liable for compensation benefits to widow of corporate employee killed on the job). *Cf.* Hanson v. Bradley, 298 Mass. 371, 10 N. E. 2d 259 (1937).

Worth noting in this connection is Section 67(d)(2) of the Bankruptcy Act, 30 STAT. 564 (1898), as

It is eminently proper to require that the shareholder and incorporator must, as the price for the privilege of corporate personality and limited liability, finance the enterprise in such fashion as to enable it to meet the normal and expectable strains of a business of the size and character involved.[45] Failure to honor this standard will impose upon him personal liability for obligations incurred in the execution of the business and will preclude his sharing as a creditor for sums advanced as loans to the business.[46]

Needless to say, the standard of adequate capital is slippery and difficult to apply. In recent years it has received much attention, especially in connection with the problem of subsidiary and affiliated corporations, as will appear below. A recent case in which the court was concerned with the application of this standard in a one-man company is *Arnold v. Phillips*.[47] Here an entrepreneur who wished to operate a brewery formed a corporation with an authorized share capital of $50,000 and paid cash for the shares. He then advanced $75,000 as a loan in order to enable the company to begin business. The venture lost heavily. Two years after incorporation he advanced large sums as loans. Upon the subsequent insolvency of

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amended, 54 STAT. 835 (1940), 11 U. S. C. §107(d)(2) (1946). This provision declares: "Every transfer made and every obligation incurred by a debtor within one year prior to the filing of a petition in bankruptcy . . . by or against him is fraudulent . . . ; or (b) as to then existing creditors and as to other persons who became creditors during the continuance of a business or transaction, if made or incurred without fair consideration by a debtor who is engaged or is about to engage in such business or transaction, for which the property remaining in his hands is an unreasonably small capital, without regard to his actual intent; or (c) as to then existing future creditors, if made or incurred without fair consideration by a debtor who intends to incur or believes that he will incur debts beyond his ability to pay as they mature. . . ."

A similar provision is found in Section 5 of the Uniform Fraudulent Conveyance Act. 9 U. L. A. Sec. 5 (1918).

[45] Fuller, *supra* note 43, at 1382: "It may not be unreasonable to expect that the requirement with respect to the relative amount of capital necessary to insure a sole shareholder against personal liability may be less exacting than when the parent-subsidiary relationship is involved, because the subsidiary corporation is really seeking a double insulation."

Note, *Inadequately Capitalized Subsidiaries*, 19 U. OF CHI. L. REV. 872 n. 1 (1952): "There appears to be no reason why a distinction should be made between parent corporations as stockholders and the stockholder in the 'one-man' corporation in the case of corporations organized with inadequate capital. However, liability appears to be more frequently limited when the stockholder is not a corporate entity."

[46] Cases cited in note 44, *supra*. In Hanson v. Bradley, 298 Mass. 371, 380, 381, 10 N. E. 2d 259, 263-264 (1937), the court complained: "The original purpose of laws permitting the formation of corporations was to enable stockholders to put at the risk of the business capital reasonably adequate for its needs, and thereby keep free from that risk their uninvested assets and their personal responsibility. . . .

Incorporators have not always been satisfied to take even the limited risk just stated. They have sought to make available to general creditors, even to tort creditors, only an amount of capital which is either illusory or trifling compared with the business to be done, while the incorporators advance the capital really necessary for the business in the capacity of competing creditors, or even in that of secured creditors. In other words, they seek personal immunity without providing any fund to which creditors may resort. This is not unusual in the organization of corporations which are subsidiaries or affiliates of others, but the practice is not confined to them."

[47] 117 F. 2d 497 (5th Cir. 1941), *cert. denied* 313 U. S. 583 (1941). The court said (p. 502): "It is not denied that a corporation, owned by one man save for qualifying shares, is lawful in Texas. That it was created to shield the owner from liability beyond the capital set up by the charter does not show an unlawful or fraudulent intent, for that is a main purpose of every incorporation. It becomes an evidence of fraud only when the capital is unsubstantial and the risk of loss great, or the contributions to capital are greatly overvalued, and the like."

the enterprise it was held that the first advance of $75,000 should be treated as a capital contribution, not recoverable by him, but that the later advances should be treated as genuine loans, for which he could share as a corporate creditor.[48]

E. Competing Equities of Personal and Business Creditors

There has been occasion under the preceding headings to mention the respective positions of the personal creditors and the business creditors. The problem presents no difficulty when there are no circumstances calling for disregard of corporate personality. As already observed, the line of demarcation between the business unit and the shareholder's personal affairs serves to mark the respective positions of the shareholder, the business creditors, and the personal creditors. The corporate or business creditor cannot reach the shareholder's individual property; conversely, his personal creditors cannot reach the corporate property; the shareholder may share as a corporate creditor for sums loaned to the business; and it is immaterial to those results that insolvency has overtaken the shareholder, or the corporation, or both.

On the other hand, if there are circumstances calling for disregard of corporate personality, this problem of the respective positions of the personal and the business creditors presents great difficulty. Assuming that corporate personality is to be disregarded, the formal consequence is that "the corporation" vanishes and a sole proprietorship occupies the entire scene. The particular practical results would be: (1) the erstwhile sole or principal shareholder will not enjoy limited liability; (2) he will not be permitted to share as a corporate creditor and will be denied reimbursement for "loans" advanced to the business; and (3) all the assets remaining after secured or lien creditors have exhausted their security will constitute a common fund for the satisfaction of the unsecured claims held by the business and the personal creditors alike. There could be no quarrel with the first two results, but the third result may be open to question. When insolvency has overtaken the business venture, or the shareholder, or both, the competing equities of the personal and the business creditors may justify or require a marshaling of assets. It may be proper or necessary to give the business creditors priority in the business assets, and the personal creditors priority in the personal assets, or to make some other alignment, under the particular circumstances.

The point of the matter is that disregard of corporate personality is no open

[48] Anderson v. Abbott, 321 U. S. 349, 361, 362, 363 (1944): "Normally the corporation is an insulator from liability on claims of creditors. The fact that incorporation was desired in order to obtain limited liability does not defeat that purpose. . . . But there are occasions when the limited liability sought to be obtained through the corporation will be qualified or denied. Mr. Justice Cardozo stated that a surrender of that principle of limited liability would be made 'when the sacrifice is essential to the end that some accepted public policy may be defended or upheld. . . .' The cases of fraud make up part of that exception. . . . But they do not exhaust it. An obvious inadequacy of capital, measured by the nature and magnitude of the corporate undertaking, has frequently been an important factor in cases denying stockholders their defense of limited liability. . . . That rule has been invoked even in the absence of a legislative policy which undercapitalization would defeat. It becomes more important in a situation such as the present one where the statutory policy of double liability will be defeated if impecunious bank-stock holding companies are allowed to be interposed as non-conductors of liability. It has often been held that the interposition of a corporation will not be allowed to defeat a legislative policy, whether that was the aim or only the result of the arrangement."

sesame of solution.[49] In the wake of disregarding corporateness there may be need of adjustments in order to resolve the conflicting equities of rival claimants. The lack of authority in these matters may indicate that the full implications of the problem have not been perceived. A more detailed analysis is found at the close of the succeeding discussion of the subsidiary corporation. The sentiments expressed regarding the analogous situation there presented are believed to be pertinent and controlling here.

An example which will serve to illustrate one aspect of this problem and to conclude the discussion is found in those cases where debtors resort to the one-man company or family corporation as a device to defraud creditors. A financially embarrassed merchant who wishes to hinder his creditors will sometimes form a close corporation, transfer the business to it, take in return all or most of the shares, and operate the business as a corporate officer at a fixed salary, with the dominion he enjoyed as a sole proprietor. In cases of this kind the courts disregarded corporate personality, of course, and permit the defrauded creditors to trace and seize the assets transferred.[50] No one would question this result, standing by itself. However, consideration must also be given to those persons who have innocently dealt with and subsequently extended credit to the business on a corporate basis. There is authority indicating that these subsequent creditors will enjoy priority in the corporate assets over the former creditors whom the incorporator sought to defraud.[51] On the other hand, if the former creditors act promptly and through legal action acquire a lien on the assets transferred to the corporation, before the new corporate creditors acquire such a lien, the former creditors' prior lien will prevail.[52] Thus, the position of the defrauded creditors will depend on the diligence with which they have followed their debtor's affairs and the timeliness with which they have moved. The respective equities of the two groups of creditors are adjusted by favoring the new creditors over the old creditors unless the latter have been active and alert.

The good faith or innocence of a claimant is even more important than his diligence. For example, in the *Sampsell* case[53] *X*, a financially embarrassed sole pro-

[49] ELVIN R. LATTY, SUBSIDIARIES AND AFFILIATED CORPORATIONS 7 (1936): ". . . even when the point of 'disregarding' the entity is once reached, this 'disregard' may leave one only at the threshold of the solution to the problem under consideration."

[50] Bennett v. Minott, 28 Ore. 339, 39 Pac. 997, 44 Pac. 283 (1896); Kellogg v. Douglas County Bank, 58 Kan. 43 (1897); First National Bank of Chicago v. Trebein Co., 59 Ohio St. 316, 52 N. E. 834 (1898). In the case last cited the court said (p. 837): "The corporation was in substance another F. C. Trebein. His identity as owner of the property was no more changed by his conveyance to the company that it would have been by taking off one coat and putting on another." In another case it is said that "such a corporation is a mere parasitic growth, a mass of fungus, which will be lopped off clean whenever necessary to sound results." Matchan v. Phoenix Land Investment Co., 159 Minn. 132, 138, 198 N. W. 417, 420 (1924).

[51] See Jackson v. N. H. Thomas Investment Co., 46 F. 2d 252 (5th Cir. 1931); Folsom & Co. v. Detrick Fertilizer Co., 85 Md. 52, 36 Atl. 446 (1897).

Sampsell v. Imperial Paper & Color Corp., 313 U. S. 215 (1941), takes a different position, though the decision itself is easily distinguishable on other grounds. Here the corporate creditor knew all the material facts when his claim arose; indeed, he had helped in the formation of the corporation and was in effect a party to the fraud.

[52] Booth v. Bunce, 33 N. Y. 139 (1865).

[53] Sampsell v. Imperial Paper & Color Corp., 313 U. S. 215 (1941).

prietor, transferred his assets to a family corporation formed for the purpose of hindering his creditors. *Y* extended credit to the corporation with full knowledge of these facts. Upon the subsequent bankruptcy of *X* the court ordered the seizure of the corporate assets as part of *X*'s bankrupt estate. *Y* contended that in the distribution of the corporate assets he was entitled to priority over the individual creditors whom *X* had sought to defraud. *Y*'s claim for priority was denied. This seems a fair result. Under the circumstances presented the equity of the shareholder's defrauded individual creditors was stronger than that of the corporate creditor.

Similarly, in *Hanson v. Bradley*[54] an employee of a one-man company which had been formed with nominal capital and was insolvent sought to hold the sole shareholder personally liable for wage claims. The court held the employee could not succeed, since he was fully aware of all the facts when his claim arose.[55]

II

The Subsidiary Corporation[56]

Although the subsidiary corporation has been most extensively used, and has reached its acme of evolution, in the field of public utilities, it has been widely used in other areas of commercial endeavor.[57] Among the many reasons for its adoption and use are: the desire for greater facility in financing, the avoidance of taxation, and the elimination of cumbersome management structures.[58] A basic factor has

[54] 298 Mass. 371, 10 N. E. 2d 259 (1937).

[55] The shareholder had advanced funds as a loan to the corporation and had taken a lien on the corporate assets as security for repayment. The employee was also seeking to set aside this lien, but did not succeed.

In its opinion the court first delivers a general condemnation of arrangements to form corporations with inadequate capital, and then says (298 Mass. at 382, 10 N. E. 2d at 264): "The plaintiff was not wronged by the fact that the corporation was organized with a trifling capital and could not live except upon borrowed money; nor by the fact that the lenders insisted on security. He knew the essential facts and accepted the situation."

[56] ELVIN R. LATTY, SUBSIDIARIES AND AFFILIATED CORPORATIONS (1936); FREDERICK J. POWELL, PARENT AND SUBSIDIARY CORPORATIONS (1931).

The provocative study by Latty is now the classic in the field and has become the Mecca of courts and commentators. Latty makes great sport of the business of lifting and piercing veils and the other verbal artifices of the courts, which fail to articulate the policy factors that constitute the causal core of decision. He well recognizes, of course, that the decisional structure erected by the judges is sound and commendable, despite the verbal shabbiness of its façade. He says (p. 3): "While the decisions have on the whole been an admirable feat of social engineering, their rationalizations have been in terms of mechanical formulae which fail when put to the test, and which do not reveal the real dynamic forces at work."

[57] Mr. Justice Jackson, dissenting, in Anderson v. Abbott, 321 U. S. 349, 379-380 (1944): "If to legislate were the province of this Court, we would be at liberty candidly to exercise discretion toward the undoing of the holding company. Some of us feel that as utilized in this country it is, with a few exceptions, a menace to responsible management and to sound finance, shifting control of local institutions to absentee managements and centralizing in few hands control of assets and enterprises bigger than they are able well to manage—views which are matters of record." See Berle, ***The Developing Law of Corporate Concentration,*** 19 U. OF CHI. L. REV. 639 (1952).

[58] The process of multiple incorporation is used to split up a business into its component parts. For instance, the enterprise of producing and selling a given item may be divided into the manufacture of the product and the marketing of the product. Thus, a corporation formed in Ohio for the purpose of manufacturing and selling tires causes the formation of a subsidiary in Delaware. The parent then manufactures tires and sells them only to the subsidiary, which in turn markets them to the public. McLean v. Goodyear Tire & Rubber Co., Inc., 85 F. 2d 150, 151 (5th Cir. 1936): "The Ohio

been the wish to avoid the difficulty or the impossibility of a concern's qualifying as a foreign corporation in a given state. A corporation formed in one state, and wishing to do business in another state, may find it either convenient[59] or necessary[60] to have a subsidiary formed in the latter state for this purpose.

A potent, though not a paramount, motive for the use of the subsidiary corporation has been the desire for limited liability. An individual who wishes to avoid the risk of submitting his entire fortune to the vicissitudes of a business may incorporate and may, through the limited liability thus attained, dedicate only a portion of his estate to the venture. In the same way, a corporation which wishes to risk only a portion of its assets in a particular sphere of the business may form a subsidiary for this purpose and may, through the additional limited liability thus attained, dedicate only a portion of its assets to that particular segment of the business. So, by the process of further incorporation there is obtained further insulation from liability.

A. The Parent and Subsidiary as Separate Units

Two factors appear as constants in the parent-subsidiary relationship: (1) The parent corporation owns all, or a majority of, or a controlling interest in the subsidiary's shares. Sometimes the same persons own all, or a majority of, or a controlling interest in the shares of both corporations. (2)Both corporations have common, or identical, directors and officers.

The presence of these two factors is not of itself sufficient ground for disregarding the separate corporate personalities of the two units. The parent and subsidiary are treated as separate and distinct persons, pursuant to the legal entity theory, even though the parent owns all the subsidiary's shares and the two corporations have identical directors and officers.[61] In the language of a typical judicial declaration:[62]

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corporation had the right to create the subsidiary for the purpose of dividing its business and . . . for the purpose of its usual business, not involving fraud or infringement upon the rights of third parties, they are to be considered separate entities." So, a corporation formed for the purpose of manufacturing rubber products may decide to become a mere holding company and lease its various plants to a subsidiary organized for the purpose of operating them. See U. S. Rubber Co. v. Query, 19 Fed. Supp. 191 (D. S. C. 1937).

[59] For example, suppose a Maine corporation wishes to do business in Alabama and discovers that the latter bestows on its corporations certain advantages not enjoyed by corporations formed elsewhere. In order to reap the benefit of these advantages, the corporation does not enter Alabama as a foreign corporation, but instead has a subsidiary formed in that state for the purpose of doing local business there. See Cannon Mfg. Co. v. Cudahy Packing Co., 267 U. S. 333, 335, 336, 337 (1925).

[60] For example, a Vermont railroad company wishes to join to its line a roadbed lying in Massachusetts, but the law of that state requires that railroads in the state must be operated by its own corporations. The Vermont company thereupon has a subsidiary formed in Massachusetts to operate the roadbed there. See Central Vermont Ry. v. Southern New England R. R., 1 Fed. Supp. 1004 (D. Mass. 1932). Similarly, Mexican law forbids foreign corporations to operate oil wells within fifty kilometers of the coast. An American corporation wishing to operate free of this restriction simply resorts to the device of organizing a string of Mexican subsidiaries manned by Mexican officers. See New York Trust Co. v. Island Oil & Transport Corp., 34 F. 2d 655 (2d Cir. 1929). See also notes 72 and 73, *infra*.

[61] Dabney v. Chase National Bank of City of New York, 98 F. Supp. 807 (S. D. N. Y. 1951). *Cf.* Bigelow v. R. K. O. Radio Pictures, Inc., 170 F. 2d 783 (7th Cir. 1949), noted in 33 MARQ. L. REV. 123 (1949). See Albert v. McGrath, 104 F. Supp. 891, 897 (S. D. Cal. 1952).

[62] Commerce Trust Co. v. Woodbury, 77 F. 2d 478, 487 (8th Cir. 1935). For similar language see

Few questions of law are better settled than that the corporation is ordinarily a wholly separate entity from its shareholders, whether they be one or more. . . . Likewise we think it must be conceded that neither ownership of all of the stock of one corporation by another, nor the identity of officers in one with officers in another, creates a merger of the two corporations into a single entity, or makes one either the principal or the agent of the other.

Ownership of shares in a corporation normally carries with it certain rights, such as the right to vote for directors, to adopt by-laws, to vote on fundamental changes, and so forth. These rights are, as a matter of verbal convenience, bundled together under the name-tag of "control." The fact that a parent corporation, in its character as sole or majority shareholder of the subsidiary, acquires and exercises such control does not assimilate the two units. After all, this control is merely an incident of the ownership of shares and is recognized by law as a normal matter of corporate procedure. A corporate shareholder is entitled, no less than a human shareholder, to exercise the control which shareholdership carries.[63]

It is frequently held, in keeping with these principles, that the parent corporation is not liable for the contracts and torts of the subsidiary, even though the former holds all the latter's shares and the directors and officers of both corporations are the same.[64] Conversely, the subsidiary is not liable for the contracts and torts of the parent corporation.[65]

In the same way, the parent and subsidiary are frequently regarded as separate units for other legal purposes, such as determining the incidence of taxation[66] and

Garden City Co. v. Burden, 186 F. 2d 651, 653 (10th Cir. 1951); Henderson v. Rounds & Porter Lumber Co., 99 F. Supp. 376, 381 (W. D. Ark. 1951); Centmont Corp. v. Marsch, 68 F. 2d 460, 463 (1st Cir. 1933); Martin v. Development Co. of America, 240 Fed. 42, 45 (9th Cir. 1917).

[63] See Taylor v. Standard Gas & Elec. Co., 96 F. 2d 693, 706 (10th Cir. 1938); Greenbaum v. Lehrenkrauss Corp. 73 F.2d 285 (2d Cir. 1934); Exchange Bank of Macon v. Macon Construction Co., 97 Ga. 1, 6, 25 S. E. 326, 328 (1895): "It makes no difference in principle whether the sole owner of the stock of a corporation is a man or another corporation. The corporation owning such stock is as distinct from the corporation whose stock is so owned as the man is from the corporation of which he is the sole member."

[64] Constitution Publishing Co. v. Dale, 164 F. 2d 210 (5th Cir. 1947) (tort); Kulukundis v. Dean Stores Holding Co., Inc., 132 Conn. 685, 47 A. 2d 183 (1946) (rent due on subsidiary's lease); Ohio Edison Co. v. Warner Coal Corp., 79 Ohio App. 437, 72 N. E. 2d 487 (1946) (contract claim); North v. The Higbee Co., 131 Ohio 507, 3 N. E. 2d 391 (1936) (rent due on subsidiary's lease); Owl Fumigating Corp. v. California Cyanide Co., 24 F. 2d 718 (D. Del. 1928), *aff'd*, 30 F. 2d 812 (3rd Cir. 1929) (patent infringement by subsidiary); Majestic Co. v. Orpheum Circuit, Inc., 21 F. 2d 720 (8th Cir. 1927) (rent due on subsidiary's lease); Pagel, Horton & Co. v. Harmon Paper Co., 236 App. Div. 47, 248 N. Y. Supp. 168 (4th Dep't 1932) (supplies purchased by subsidiary). See American Cyanamid Co. v. Wilson & Toomer Fertilizer Co., 51 F. 2d 665 (5th Cir. 1931); Finley v. Union Joint Stock Land Bank of Detroit, 281 Mich. 214, 274 N. W. 768 (1937).

[65] McLean v. Goodyear Tire & Rubber Co., Inc., 85 F. 2d 150 (5th Cir. 1936); Kingston Dry Dock Co. v. Lake Champlain Trans. Co., 31 F. 2d 265 (2d Cir. 1929). *Cf.* The J. B. Austin, Jr., 1 F. 2d 451 (D. N. Y. 1924). For a discussion of this point see Note, 43 YALE L. J. 472 (1934).

[66] See Commissioner of Internal Revenue v. Oxford Paper Co., 194 F. 2d 190 (2d Cir. 1952); Warrior River Terminal Co. v. State, 58 So. 2d 100 (Ala. 1952); Rexall Drug Co. v. Peterson, 248 P. 2d 433 (Cal. App. 1952); Commonwealth v. Gulf Oil Corporation, 359 Pa. 583, 60 A. 2d 46 (1948). *Cf.* Superior Coal Co. v. Department of Finance, 377 Ill. 282, 36 N. E. 2d 354 (1941). In U. S. Rubber Co. v. Query, 19 F. Supp. 191 (E. D. S. C. 1937), a New Jersey corporation owned various plants throughout the country, including one in South Carolina. These plants were leased to and operated by a subsidiary formed for the purpose in Delaware. In deciding that the New Jersey holding

settling problems of judicial jurisdiction and service of process.[67] Likewise, it is held that a person employed by a subsidiary is not an employee of the parent corporation.[68]

B. Fusion of Parent and Subsidiary

The rules previously discussed concerning disregard of corporate personality are, of course, applicable to the parent-subsidiary relation.[69] It is clear that corporate personality will be disregarded, and the two units will be "fused," wherever "the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime."[70]

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company was not doing business in South Carolina and was not subject to a franchise tax imposed by that state, the court said (p. 194): "Through stock ownership, interlocking directorates and identity of controlling officers, plaintiff controls the Rubber Products Company. The two corporations occupy the same offices in New York City, but each maintains its separate corporate identity, the persons who are officers performing for each corporation the duties pertaining to their offices in that corporation, and transactions between the two corporations being accurately recorded in their corporate books and records."

[67] For example, a corporation formed in state *A* has a subsidiary formed in state *B* for the purpose of doing local business in state *B*. The parent corporation is not considered to be doing business in, and is not subject to suit in, state *B*. Cannon Mfg. Co. v. Cudahy Packing Co., 267 U. S. 333 (1925); La Varre v. International Paper Co., 37 F. 2d 141 (D. S. C. 1929); Missouri-Kansas Pipe Line Co. v. Hobgood, 244 Ky. 570, 51 S. W. 2d 920 (1932).

Service of process upon a local subsidiary is not equivalent to service of process upon the foreign parent. Steinway v. Majestic Music Co., 179 F. 2d 681 (10th Cir. 1949). See Mas v. Nu-Grape Co. of America, 62 F. 2d 113 (4th Cir. 1932). The problem is discussed in Note, 45 ILL. L. REV. 291 (1950).

The result is otherwise if the subsidiary is a mere "agency" or "instrumentality" of the parent. In that event, the business done in the state by the subsidiary is held to render the parent present in the state and to subject it to suit there. Society Milion Athena v. National Bank of Greece, 166 Misc. 190, 2 N. Y. Supp. 2d 155 (1937), *aff'd*, 253 App. Div. 650, 3 N. Y. 2d 677 (1st Dep't 1938). See also Industrial Research Corp. v. General Motors Corp., 29 F. 2d 632 (D. Ohio 1928); Williams v. Freeport Sulphur Co., 40 S. W. 2d 817 (Tex. Civ. App. 1931), 30 MICH. L. REV. 464 (1932).

[68] Wheeler v. New York, N. H. & H. R. R., 112 Conn. 510, 153 Atl. 159 (1931). *Accord:* Press Co., Inc. v. National Labor Relations Board, 118 F. 2d 937 (D. C. Cir. 1940), *cert. denied*, 313 U. S. 595 (1941). *Cf.* Bethlehem Steel Co. v. National Labor Relations Board, 120 F. 2d 641 (D. C. Cir. 1941).

[69] Indeed, the leading American decision concerning disregard of corporate personality was precisely one involving a parent corporation and its subsidiary. United States v. Milwaukee Refrigerator Transit Co., 142 Fed. 247 (D. Wis. 1905). Here it was found that a brewing company had formed a subsidiary transit company in order to obtain shipping rebates from railroads, in violation of federal law, and the federal government's request for an injunction breaking up the practice was granted. *Accord*: Federal Gravel Co. v. Detroit & Machinac Railway, 248 Mich. 49, 226 N. W. 677 (1929).

Nashville, C. & St. L. Ry. v. Faris, 166 Tenn. 238, 244, 60 S. W. 2d 425, 426-427 (1933): "No principle of law is better settled than that which holds that where a corporation resorts to the subterfuge of creating a 'dummy' corporation to be used as its agency or instrumentality, for the purpose of avoiding liability or furthering its illegal designs, they will be treated as one and the same."

Dabney v. Chase National Bank of City of New York, 98 F. Supp. 807, 837 (S. D. N. Y. 1951): "The law with respect to ignoring the corporate fiction is clear in its insistence upon factors indicating such a unity of relationship among formally independent corporate entities that an adherence to the principle of separate existence would work a fraud or other injustice."

A special aspect of this problem is discussed in Note, *Disregarding Separate Corporate Entities to Preserve an Integrated Economic Structure*, 47 COL. L. REV. 109 (1947).

[70] See note 33, *supra*. In Rippel v. Kaplus, 124 N. J. Eq. 303, 1 A. 2d 883 (Ch. 1938), confirmation of a mortgage foreclosure sale was opposed by the mortgagor, a corporation, on the ground that the latter was a helpless and penniless debtor unable to protect itself by bidding at the sale. All the shares of the mortgagor were owned by another corporation, and there was nothing to show that the latter was financially unable to satisfy the mortgage. The court confirmed the sale and remarked (124 N. J. Eq. at 305, 1 A. 2d at 884): "This is a case in which the corporate entity of the obligor should be disregarded; it is not an appeal of a distressed and helpless debtor." See Seymour v. Woodstock & Sycamore

This brief statment will serve as sufficient preface to two particular problems in which disregard of corporate personality has special significance in the parent-subsidiary pattern.

The first of these concerns the subsidiary which is formed in order to overcome a legal restriction imposed by a given jurisdiction. The legislature of a state will sometimes declare that certain activities (such as operating a railroad, drilling oil wells, acquiring land by eminent domain) may be carried on within the state only by its own domestic corporations.[71] A foreign corporation wishing to engage in these activities in that state will simply resort to the practice of organizing a subsidiary in that state for this purpose. There is a striking Arkansas decision holding that this practice is not successfully impeachable as an evasion and that the parent corporation is entitled to retain the advantage thus sought and secured.[72] There is also authority to the contrary.[73]

No doubt the result in a given case will depend on the nature and purpose of, and the judicial attitude towards, the restriction in question. The local courts may consider the restriction relatively trifling or parochial; on the other hand, they may consider it one which serves a desirable policy. It would be an easy matter for the court to sanction the parent's conduct in the first case, and to condemn the parent corporation for evasion in the second case. The "well established" theory of corporate entity will serve as the rationalizing peg in the first case, and the equally "well

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Traction Co., 281 Ill. 84, 117 N. E. 729 (1917), 31 HARV. L. REV. 894 (1918). In Rapid Transit Subway Construction Co. v. City of New York, 259 N. Y. 472, 182 N. E. 145 (1932), the plaintiff, a corporation, sued the City of New York to recover damages for breach of contract. It was shown that the breach was attributable to the conduct of another corporation which owned all the shares of the plaintiff. The court denied recovery and said (259 N. Y. at 491, 182 N. E. at 151): "Exemption from liability for wrong committed by the corporation whose stock it owns is inherent in the privilege, accorded to it by law, of conducting its business in corporate form: exemption from the consequences of its own acts working injustice upon parties with which it deals is a perversion of that privilege."

[71] See note 60, *supra*, and notes 72 and 73, *infra*.

[72] Patterson Orchard Co. v. Southwest Arkansas Utilities Corp., 179 Ark. 1029, 18 S. W. 2d 1028 (1929): A corporation was formed in Arkansas, took land by eminent domain there, and leased the land to a Delaware corporation. The Arkansas company was formed as a subsidiary of the Delaware company in order to acquire the land, since the constitution of Arkansas denied foreign corporations the privilege of eminent domain and rendered the Delaware company powerless to obtain the land for itself directly. The court upheld the transaction, over the objection of the party whose land had been thus condemned and acquired. The court (p. 1032) conceded that "There are, perhaps, some unusual circumstances connnected with this case," but concluded that the contestant had not been "defrauded in any way" and that the Delaware company had merely resorted to a proper legal device to obtain the right-of-way which it thought necessary for the conduct of its business and which it had been unable to obtain by any other method from the appellant." See Irvine Co. v. Bond, 74 Fed. 849 (S. D. Cal. 1896).

[73] State v. Safford, 117 Ohio 576, 582, 159 N. E. 829, 830-831 (1927): "The principle of denying the right to do by indirection what cannot be done by direct method is thus clearly recognized. If a non-resident insurance company cannot write insurance in Ohio without a resident license, how can this desired result be acquired by coming into the state in the guise of an owner of a controlling interest in a domestic corporation, thus seeking to circumvent the statute relative to resident licenses?" *Cf.* New York Trust Co. v. Island Oil & Transport Co., 34 F. 2d 655 (2d Cir. 1929); Central Vermont Ry. v. Southern New England R. R., 1 Fed. Supp. 1004 (D. Mass. 1932); General Motors Acceptance Corp. v. Commissioner of Banks, 258 Wis. 56, 45 N. W. 2d 83 (1950), noted in 5 VAND. L. REV. 637 (1952).

established" rule for disregarding corporate personality will serve to justify the decision in the second case.

Much more important for present purposes is the second particular problem mentioned above. This problem is the matter of the legal and financial criteria which are to govern the operations of a parent corporation and its subsidiary.

The activities of a parent corporation and its subsidiary should conform to the following four standards: (1) Adequate financing of the subsidiary as a separate unit. The subsidiary should be established as a separate unit sufficiently financed to meet the normal obligations and usual strains expectable in a business of its size and character. (2) Sedulous avoidance of intermingling. The business transactions of the two units should be kept distinct; separate accounts and records should be maintained. (3) Careful observance of the formalities of separate corporate procedures. The formal distinction between the two boards of directors and two sets of officers should be honored, even though the directors and officers of both corporations are the same persons; the formalities of separate corporate action, such as the ritual of separate meetings, should be fully observed and the dual capacities of the directors and officers thus kept defined. (4) Avoidance of representations blurring the division between the two units. The two units should not be held out to the public as being merely one.[74]

When these standards are observed, a parent and its subsidiary will normally be treated as separate entities, and the obligations and liabilities of the one will be kept distinct from those of the other, in accordance with the principles already discussed. A failure to honor one or more of these requirements may be fatal. The court may disregard corporate personality and consider the parent and subsidiary "assimilated" for legal purposes.[75] Consequently, liability may be imposed on the parent for contracts and torts of the subsidiary.[76]

Three well known cases which supply illustrative contour to the problem may be briefly considered.

The first case is *Luckenbach S. S. Co., Inc. v. W. R. Grace & Co.*,[77] decided in 1920 by the United States Court of Appeals for the Fourth Circuit. Here a corporation capitalized at $800,000 rented its fleet of steamers to a subsidiary, capitalized at $10,000, for the purpose of operating the vessels. Both corporations had the same officers and 90 per cent of the shares in each corporation were held by the person who was president and general manager of both units. The parent was held liable for a breach of contract by the subsidiary, since "it would be unconscionable to allow the owner of this fleet of steamers, worth millions of dollars, to escape liability be-

[74] This analysis is made in Douglas and Shanks, *Insulation from Liability Through Subsidiary Corporations*, 39 YALE L. J. 193, 196 ff. (1929).

[75] Fish v. East, 114 F. 2d 177 (10th Cir. 1940); Pacific Can Co. v. Hewes, 95 F. 2d 42 (9th Cir. 1938); Herman v. Mobile Homes Corp., 317 Mich. 233, 26 N. W. 2d 757 (1947).

[76] Cases cited in the following six notes. Other consequences which ensue upon assimilation of the two units are discussed under subsequent headings in the text. See also note 67, *supra*.

[77] 267 Fed. 676 (4th Cir. 1920).

cause it had turned them over a year before to a $10,000 corporation which is simply itself in another form."[78]

The second case is *Ross v. Pennsylvania R. R.*,[79] decided in 1930 by the New Jersey courts. Here a person was struck and killed in New Jersey by a negligently operated train of West Jersey & Seashore Railroad Company, which employed and paid the wages of the engineers and the other members of the train crew. This company was a subsidiary of the Pennsylvania Railroad Company. The name "West Jersey and Seashore R. R. Co.," formerly on the fenders of the locomotive, had been removed and the word "Pennsylvania" substituted; the word "Pennsylvania"' appeared on the coaches of the train; the letters "P. R. R." appeared on the uniforms of some of the crew; a time table captioned "Pennsylvania Railroad System" listed the train on the schedules therein contained. The decedent's administrator wrote two letters concerning the accident to the Pennsylvania Railroad Company and the latter's district claim agent answered both on the merits. In a suit by the administrator to recover damages from the Pennsylvania Railroad Company, the lower court submitted to the jury the issue whether that company was controlling and operating the train at the time of the accident. The jury returned a verdict for the plaintiff, and the lower court entered judgment on the verdict. On appeal it was held proper to submit the issue to the jury and the judgment was affirmed.[80]

The third case is *Costan v. Manila Electric Co.*,[81] decided in 1928 by the United States Court of Appeals for the Second Circuit. Here Manila Electric Company held title to and operated a street railway in Manila. All its shares, excepting those necessary to qualify directors, were held by Manila Electric Corporation. The directors of the latter, acting through a committee, appointed a party to act as manager of the Manila property and conferred upon him broad powers (hiring of employees, purchase of supplies, and so forth), subject to "such general supervision and control as may be exercised by the directors" of the parent company. This manager was to receive $25,000 for his services—$5,000 from the parent, $20,000 from the subsidiary. While this arrangement prevailed, a person was injured by the negligent operation of a car on the Manila Street Railway. He sued the holding company for damages. It was held that the lower court committed reversible error in entering a compulsory nonsuit. Liability may be fixed on the parent corporation because by an obtrusive act of intervention it entrusted complete control over the subsidiary's property to a third party who was subject only to the will of the parent's directorate.

[78] 267 Fed. at 681. *Accord:* Wallace v. Tulsa Yellow Cab Taxi & Baggage Co., 61 P. 2d 645 (Okla. 1936); Garden City Co. v. Burden, 186 F. 2d 651 (10th Cir. 1951) (tort claim based on subsidiary's negligent operation of an irrigation canal); Henderson v. Rounds & Porter Lumber Co., 99 F. Supp. 376 (W. D. Ark. 1951) (contract claim). See Herman v. Mobile Homes Corp., 317 Mich. 233, 26 N. W. 2d 757 (1947) (contract claim).

[79] 106 N. J. L. 536, 148 Atl. 741 (1930), 43 HARV. L. REV. 1154 (1930).

[80] *Accord:* Mangan v. Terminal Transportation System, Inc., 157 Misc. 627, 284 N. Y. Supp. 183 (Sup. Ct. 1935). See Weisser v. Mursam Shoe Corporation, 127 F. 2d 344 (2d Cir. 1942); Davis v. Alexander, 269 U. S. 114, 117 (1925). *Cf.* Berkley v. Third Avenue Railway, 244 N. Y. 84, 155 N. E. 58 (1926); Bergenthal v. State Garage & Trucking Co., 179 Wis. 42, 190 N. W. 901 (1922).

[81] 24 F. 2d 383 (2d Cir. 1928).

And the subsidiary, without part in the plan, is saddled with an obligation of $20,000 to boot.[82]

The *Costan* case indicates that the result in a given situation may turn on formal aspects of "control." The parent corporation's control, exercised as a normal legal incident of shareholdership and through the usual rituals of discrete corporate procedures, is one thing. Dominion exercised by the parent over the subsidiary's affairs in a "direct" or "obtrusive" manner is another thing. The former is judicially sanctioned, with the consequence that the separate corporate personality of each unit is sustained. The latter is judicially condemned, with the consequence that corporate personality will be disregarded and the two units will be assimilated.

Justice Learned Hand, incomparable for his sense of the practical in litigation, has neatly capped the matter in these words:[83]

> Control through the ownership of shares does not fuse the corporations, even when the directors are common to each. One corporation may, however, become an actor in a given transaction, or in part of a business, or in a whole business, and, when it has, will be legally responsible. To become so, it must take immediate direction of the transaction through its officers, by whom alone it can act at all. . . . liability normally must depend upon the parent's direct intervention in the transaction, ignoring the subsidiary's paraphernalia of incorporation, directors, and officers. The test is, therefore, rather in the form than in the substance of the control, in whether it is exercised immediately, or by means of a board of directors and officers, left to their own initiative and responsibility in respect of each transaction as it arises. Some such line must obviously be drawn, if shareholding alone does not fuse the corporations in every case.

In concluding this discussion of the four standards which should govern intercorporate behavior special mention must be made of the matter of adequate

[82] The court said (pp. 384-385): "The manager's actions are made subject only to such general supervision as may be exercised by the directors of the holding company, not of the subsidiaries whose properties are to be operated. In short, the holding company utterly disregards the Manila Electric Company as a distinct corporate entity, except perhaps for bookkeeping purposes, and deals with its properties and their operation as a street railway exactly as though the legal title were in the holding company."

Accord: McCarthy v. Ference, 358 Pa. 485, 58 A. 2d 49 (1948) (tort claim based on subsidiary's negligent maintenance of property). Here the court said (358 Pa. at 489, 58 A. 2d at 56): "It appears that at all times the Steel Corporation treated the Land Company as nothing more than a department of its own business; indeed it showed its complete disregard of any autonomy on the part of the Land Company by ignoring it entirely in the contracts which it entered into with the Railroad Company and the County; the Land Company had nothing whatever to do with the entire project, nor did it enter as an independent body into any of the negotiations or plans connected therewith."

Consolidated Rock Co. v. Du Bois, 312 U. S. 510, 523-524 (1941): "All management functions of the several companies were assumed by Consolidated. The subsidiaries abdicated. Consolidated operated them as mere departments of its own business. Not even the formalities of separate corporate organizations were observed except in minor particulars such as the maintenance of certain separate accounts. In view of these facts, Consolidated is in no position to claim that its assets are insulated from such claims of creditors of the subsidiaries. To the contrary, it is well settled that where a holding company directly intervenes in the management of its subsidiaries so as to treat them as mere departments of its own enterprise, it is responsible for the obligations of those subsidiaries incurred or arising during its management. . . . A holding company which assumes to treat the properties of its subsidiaries as its own cannot take the benefits of direct management without the burdens."

[83] Kingston Dry Dock Co. v. Lake Champlain Transp. Co., 31 F. 2d 265, 267 (2d Cir. 1929). See Taylor v. Standard Gas & Elec. Co., 96 F. 2d 693, 706 (10th Cir. 1938).

capitalization. This standard is by all odds the most important of the four, and doubtless the most elusive. It impresses the courts and weighs heavily in the judicial balance.[84] In recent years it has received increasing attention from the courts and writers.[85] Cases concerning the problem may be grouped, for convenience and merely as an aid to discussion, into three loose categories:

(1) Cases in which the subsidiary is formed with a nominal or trifling capital. Here it is common to find that the subsidiary, at the very start of its existence, has few or no assets and requires financial support for its operations. It lacks even a "minimal credit or cushion."

(2) Cases in which the subsidiary is formed with capital which is more than nominal, but which is insufficient to meet the expectable strains of a business of its size and nature.

(3) Those cases which fall under either of the first two categories and, in addition, reveal a plan to milk the subsidiary for the parent's benefit.

Cases of the first category have been easy to decide. An example is a recent case in which the subsidiary, formed to engage in the business of building homes on a large scale, was capitalized at $5000 and immediately embarked on a project requiring a credit of $1,000,000.[86]

Cases of the third category have also been easy to decide. A recent example is found in *Henderson v. Rounds & Porter Lumber Co.*[87] Here a subsidiary was created to manufacture lumber products. It sold these items below market price to the parent. The constant operating loss which resulted led to bankruptcy, even though the parent made several advances (as secured loans) to the subsidiary. The court found that the capital with which the subsidiary started ($30,000 and machinery) was sufficient for normal operations and that, in the absence of the milking by the parent, the subsidiary could have prospered, because of the great demand and high prices in the lumber products market at the time. The court concluded that under the circumstances the subsidiary should be regarded as "undercapitalized from

[84] Douglas and Shanks, *Insulation From Liability Through Subsidiary Corporations*, 39 YALE L. J. 193, 214 (1929): ". . . courts are more impressed by an obvious inadequacy of capital on the part of the subsidiary than they are by the presence of any of the other indicia of identity between the corporations. . . . In fact, sufficient capital and adequate financial arrangements or the lack of it, insofar as the various factors motivating the courts are capable of ascertainment from the cases, in some instances seems to be largely determinative."

[85] See ELVIN R. LATTY, SUBSIDIARY AND AFFILIATED CORPORATIONS 110-141 (1936); Rembar, *Claims Against Affiliated Companies in Reorganization*, 39 COL. L. REV. 907, 915 *ff.* (1939); Krotinger, *The Deep Rock Doctrine: A Realistic Approach to Parent-Subsidiary Law*, 42 COL. L. REV. 1124, 1129 *ff.* (1942). A well considered recent discussion, brief and to the point, is found in Note, *Inadequately Capitalized Subsidiaries*, 19 U. OF CHI. L. REV. 872 (1952).

[86] Herman v. Mobile Homes Corp., 317 Mich. 233, 26 N. W. 2d 757 (1947) (parent held liable for subsidiary's contractual obligations). See also the *Wallace* and *Garden City* cases, both cited in note 78 *supra*. In contrast, consider the case of Ohio Edison Co. v. Warner Coal Corp., 79 Ohio App. 437, 72 N. E. 2d 487 (1946), in which the court, holding that the parent was not liable for the subsidiary's debt, said of the subsidiary (79 Ohio App. at 439, 72 N. E. 2d at 488): "It operated the business of mining the coal and had a substantial capital reasonably regarded as adequate to enable it to operate its business and pay its debts as they matured. Various unforeseen economic factors intervened to defeat the expectation."

[87] 99 F. Supp. 376 (W. D. Ark. 1951).

the start." Accordingly, the parent was held liable to the subsidiary's creditors.[88]

The *Luckenbach* case, already considered above, may be regarded as a decision falling within the second category. That case seems clear on its facts and was apparently easy to decide. It is obvious, however, that the problem of determining adequacy of capitalization in cases of the second category may present great difficulty.

The matter of adequate versus inadequate capitalization arises frequently in cases where the parent seeks to share as a creditor for advances made to the subsidiary. These cases present the question whether the parent's advances are to be treated as genuine loans, for which the parent may share as a creditor of the subsidiary, or merely as contributions to the subsidiary's capital, for which the parent's claim must be subordinated to the claims of the subsidiary's creditors.[89] Various tests have been suggested as aids to the determination of this question.[90] A principal feature of these tests is this: The parent may not deal with the subsidiary on terms more favorable than those under which an outsider would deal with the subsidiary.[91] Advantages obtained by the parent in violation of this standard will be disregarded.

The simple truth is that the courts, obliged by the nature of the problem to treat each case on its merits, have been feeling their way step by step—not without resort to hindsight. Rigid rules and fixed formulas are futile in this area of hazy equities and judicial retrospections.[92] Although this spells disappointment for those who crave certainty, judicial achievement in this difficult area is impressive and commendable.[93]

[88] The court, speaking of its power to disregard corporate personality and to hold the parent liable for the subsidiary's debts, said that there are various "negative rules" on the subject, and continued (p. 381): "It is impossible to formulate a general rule applicable to all cases, and the courts have not attempted to do so. Rather the over all picture as it appears from the facts dictates whether or not the power should be exercised."

[89] Inadequate capitalization is an important factor in the application of the Deep Rock doctrine. A discussion of that doctrine is found in note 104, *infra*.

[90] See Boyum v. Johnson, 127 F. 2d 491 (8th Cir. 1942), and dissent in Barlow v. Budge, 127 F. 2d 440 (8th Cir. 1942). See also the next note.

Rembar, *supra*, at 915 *ff.*, suggests three tests: (1) A comparison of the subsidiary's capital with the capital of other corporations similar in size and nature. All the parent's advances which bring the subsidiary's assets up to this level are to be regarded as capital contributions. (2) The extent to which the subsidiary could have borrowed from outside sources. The parent's advances are to be regarded as capital contributions if made when the subsidiary could not have borrowed from outside sources. (3) The ratio between the parent's capital contributions and non-capital contributions. The latter must not be too great as contrasted with the former.

[91] Israels, *The Implications and Limitations of the Deep Rock Doctrine*, 42 COL. L. REV. 376, 391 (1942). He suggests that if there is a market for new shares, common or preferred, in the subsidiary, the parent must invest on that basis. The parent's advances made under such circumstances should be treated as capital contributions, not loans. "Perhaps only upon a showing that there was no market for common or preferred stock on reasonable terms would the parent be justified in lending money."

Note, *Inadequately Capitalized Subsidiaries*, 19 U. OF CHI. L. REV. 872, 874 (1952), speaking of the line between "legitimate debt and disguised capital," says: "One index is the extent to which continued long term borrowing from the parent occurs when the subsidiary could not have borrowed from outsiders."

[92] See note 88, *supra*. It is to be observed, also, that hindsight is to be applied with caution and circumspection. See note 86, *supra*.

[93] Note, *Inadequately Capitalized Subsidiaries*, 19 U. OF CHI. L. REV. 872, 875 (1952): "While

C. Legal Metaphors and Practical Realities

The orthodox judicial analysis of the parent-subsidiary relationship differs from that advanced under the preceding heading. As is to be expected, the courts resort to words of art. Their approach is this: If the subsidiary is a mere adjunct or instrumentality of the parent, the latter will be liable for the former's contracts and torts.[94] Frequent use is also made of the following words to denote synonymy to "adjunct" and "instrumentality": agency, alter ego, tool, department, conduit, double, alias, dummy, and so forth.

These words are not helpful, for they themselves need defining. Obviously, they are not incantations which produce results by the magic of utterance, but rather are verbal labels of convenience attached to results which are reached on the facts of the case. On the basis of given facts it may be felt that the parent corporation should be held liable for the contract or tort of its subsidiary. It is, of course, these facts and the decision reached which are significant.[95] To say that the parent

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subsequent activity indicates what was necessary in the beginning, the courts are faced with an overwhelming problem. Because quantitative criteria are often artificial and unjust, courts cannot be condemned for vaguely phrasing the variables contributing to their decisions. While incorporators have no yardstick with which to measure their transactions, they have been put on notice that the protection of their own funds is not enough, and theirs is the responsibility of creating a financial structure which will not unduly jeopardize creditors in the event of the subsidiary's insolvency."

[94] Atwater & Co. v. Fall River Pocahontas Collieries Co., 119 W. Va. 549, 559, 195 S. E. 99, 104 (1937): "The instrumentality rule is a modern innovation in the law of corporations. It came into being as a result of a gradual growth, brought about by the necessities of situations which confronted the courts. The development of the law on this question is still in progress, and therefore courts should invoke the rule only with mature consideration and caution. Undue haste in the application of the rule to every case involving corporations would break down the entire corporation law of the country and would bring about disastrous results."

For analysis and criticism of the "instrumentality rule" see May Department Stores Co. v. Union Electric Light & Power Co., 107 S. W. 2d 41, 53 *ff.* (Mo. 1937); Note, 21 ST. LOUIS L. REV. 234 (1936).

[95] "Each case must be regarded as sui generis," it is said, and "slight shading of the facts creates possible distinctions." Pagel, Horton & Co. v. Harmon Paper Co., 236 App. Div. 47, 49, 258 N. Y. Supp. 168, 171 (4th Dep't 1932). For similar language see Herman v. Mobile Homes Corp., 317 Mich. 233, 243, 26 N. W. 2d 757 (1947).

Care must be taken in noting and defining the particular issue presented by a case. Whether the parent is liable for the obligations of the subsidiary is one question. This question may itself turn on the nature of the obligation involved; conceivably, tort claimants and contract creditors might be treated differently for this purpose, though the courts have not addressed themselves to this difference. Whether the parent may share as a creditor for advances made to the subsidiary is another question. Whether the subsidiary's presence in a state is equivalent to the parent's presence there, in determining matters respecting jurisdiction and service of process, and whether the units are to be regarded as separate parties in determining the incidence of taxation under a particular statute, are still other problems. These and various other classes of issues which arise may be controlled by varying legal policies. For instance, in Centmont Corp. v. Marsch, 68 F. 2d 460 (1st Cir. 1933), *cert. denied*, 291 U. S. 680 (1934), the parent was not permitted to share as a creditor for advances made to the subsidiary. But in another case, involving the same parent and subsidiary, a creditor of the subsidiary was denied recovery against the parent. Marsch v. Southern New England R. R., 230 Mass. 483, 120 N. E. 120 (1918). The same dichotomy appears in the following pair of cases: *Re* Otsego Waxed Paper Co., 14 F. Supp. 15 (S. D. Mich. 1935) (parent's claim against subsidiary subordinated to claims of subsidiary's creditors), and Madden v. Mac Sim Bar Paper Co., 103 F. 2d 974 (6th Cir. 1939) (creditor of subsidiary denied recovery against the parent).

For examples of judicial sensitivity to this matter see the statements of Justice Brandeis and Judge Learned Hand in Cannon Mfg. Co. v. Cudahy Packing Co., 267 U. S. 333, 337 (1925), and New York Trust Co. v. Island Oil & Transport Corp., 34 F. 2d 655 (2d Cir. 1929).

is liable in this situation because the subsidiary is a mere adjunct or instrumentality of the parent adds no substance and gives no real reason for the decision, but merely supplies verbal justification and a metaphorical tag to the conclusion which is predicated on the facts. Beneath the verbal coating dynamic forces are at play—the unexpressed factors of legal policy which constitute the real reason for decision.[96] As Justice Cardozo, whose devotion to picturesque speech is well known, deftly declared: "The whole problem of the relation between parent and subsidiary corporations is one that is still involved in the mists of metaphor. Metaphors in law are to be carefully watched, for starting as devices to liberate thought, they often end by enslaving it."[97]

Assuming that the usual judicial analysis is to be followed, the basic question remains: What circumstances will justify calling the subsidiary a mere adjunct or instrumentality of the parent? In the usual case it is a failure to honor one or more of the four standards of behavior, described above, which is the operative fact causing the subsidiary to be considered a mere adjunct of the parent. Hence, the favorite form of judicial statement, pinned down to the cases and their factual content, reduces to this: Ownership by the parent of all the subsidiary's shares, and the presence of common or identical directors and officers, are not of themselves sufficient cause to render the subsidiary an adjunct of the parent or to assimilate the units; on the other hand, a failure to honor one or more of the four standards which should characterize the activities of a parent and its subsidiary may be sufficient cause to render the subsidiary an adjunct of the parent and to assimilate the units.[98]

D. The Parent as Creditor of the Subsidiary

A parent corporation is not permitted, upon the insolvency of a subsidiary which is a mere "adjunct," to share as creditor for sums advanced as loans to the subsidiary.[99] Conversely, the claim of the subsidiary against its insolvent parent is also

ROBERT S. STEVENS, PRIVATE CORPORATIONS 85 (2d ed. 1949): "Whether a distinction between these personalities will be made may vary with the nature of the action in which the issue is raised, and cannot be determined in one action for all purposes."

[96] Taylor v. Standard Gas Co., 306 U. S. 307, 322 (1939): The "so-called instrumentality rule," said the Court, "is not, properly speaking, a rule, but a convenient way of designating the application in particular circumstances of the broader equitable principle that the doctrine of corporate entity, recognized generally and for most purposes, will not be regarded when so to do would work fraud or injustice."

[97] Berkey v. Third Avenue Railway, 244 N. Y. 84, 94, 155 N. E. 58, 61 (1926). See also Kingston Dry Dock Co. v. Lake Champlain Transport Co., 31 F. 2d 265, 267 (2d Cir. 1921); *Re* Pittsburgh Railways Co., 155 F. 2d 477, 484 (3rd Cir. 1946); 22 BOSTON U. L. REV. 127 (1942).

[98] See Douglas and Shanks, *Insulation From Liability Through Subsidiary Corporations*, 39 YALE L. J. 193, 195 (1929); FREDERICK J. POWELL, PARENT AND SUBSIDIARY CORPORATIONS 9 *et seq.* (1931); Note, 46 HARV. L. REV. 823 (1933).

[99] Henry v. Dolley, 99 F. 2d 94 (10th Cir. 1938); *Re* Otsego Waxed Paper Co., 14 Fed. Supp. 15 (D. Mich. 1935); Central Vermont Ry v. Southern New England R. R., 1 Fed. Supp. 1004 (D. Mass. 1932); Centmont Corp. v. Marsch, 68 F. 2d 460 (1st Cir. 1933); S. G. V. Co. v. S. G. V. Co., 264 Pa. 265, 107 Atl. 721 (1919); Clere Clothing Co. v. Union Trust & Savings Bank, 224 Fed. 363 (9th Cir. 1915).

"The reason is that the proprietor of a business cannot lend money to the enterprise and thus curtail the rights of creditors by sharing in pari passu with them, and such loan is regarded as a contribution to the capital of the business." New York Trust Co. v. Island Oil & Transport Co., 56 F. 2d 580, 583

rejected.[100]

These are sound results based on the desire to protect the creditors of the two units. In the first situation the insolvent subsidiary's creditors are protected against further depletion of the assets available for the payment of their claims; in the second situation, the insolvent parent's creditors are protected against further depletion of the assets available for the payment of their claims.

In the cases which reject[101] the parent corporation's claim against the insolvent subsidiary there are present facts—such as "intermingling," failure to observe the formalities of separate corporate action, inadequate financing of the subsidiary as a separate unit—which justify calling the subsidiary a mere adjunct of the parent. Whether the same result would follow in the absence of such facts is open to question. The desire to protect the subsidiary's creditors may, conceivably, be in itself sufficient ground to induce a court to treat the subsidiary as a mere adjunct of the parent and to reject the parent's claim.[102] In the case of the one-man company it is held, as already seen, that the sole shareholder who keeps his individual affairs distinct from the corporate venture may lend money to the business and share as a creditor upon its insolvency. There appears to be no logical or practical reason why the corporate shareholder in the parent-subsidiary pattern should be treated differently in this respect from the human shareholder in the one-man company. Therefore, a parent corporation which has honored the four standards that should characterize the activities of parent and subsidiary units may, it is believed, share as a creditor for its loans to the subsidiary, upon the latter's insolvency. The available cases on the point are to this effect.[103]

Cases in which the parent seeks to share as a creditor for its advances to the subsidiary frequently raise two particular problems.

(2d Cir. 1932).

Allowance of the parent's claim would be "tantamount to allowing a debtor to prove in bankruptcy in competition with its own creditors, a result which shocks the conscience of a chancellor." Central Vermont Ry. v. Southern New England R. R., cited above, *supra* at 1005.

[100] New York Trust Co. v. Island Oil & Transport Co., 34 F. 2d 655 (2d Cir. 1929).

[101] If the parent's claim against the insolvent subsidiary is subordinated to the claims of the subsidiary's other creditors, the latter will exhaust the subsidiary's assets and leave nothing for the parent, in the usual case. Hence, in these situations subordinating the parent's claim is, for all practical purposes, equivalent to disallowing it. See Note, 47 COL. L. REV. 800, 804 n. 38 (1947).

Furthermore, when courts wish to disregard corporate personality and to assimilate the units, they do so on the premise that the subsidiary is a mere adjunct or instrumentality of the parent. Under this approach the parent cannot be considered a creditor of the subsidiary, since a party cannot assert a claim as creditor against himself. Accordingly it would be more appropriate to speak of disallowing the claim, rather than of subordinating it, in these cases.

In view of these considerations it is not surprising to find that almost all the cases dealing with these matters speak of disallowance or rejection, rather than of subordination.

See Note, *Subordination of a Parent's Claim Against a Subsidiary*, 36 ILL. L. REV. 229, 230, 232 (1941).

[102] See Note, 46 HARV. L. REV. 823, 828 (1933).

[103] See *Re* Watertown Paper Co., 169 Fed. 252 (2d Cir. 1909); Finn v. George T. Mickle Lumber Co., 41 F. 2d 676 (9th Cir. 1930); Franklin Process Co. v. Western Franklin Process Co., 308 Ill. App. 302, 31 N. E. 2d 364 (1941); Note, 37 MICH. L. REV. 440 (1939); Note, 45 YALE L. J. 1471 (1936). *Cf.* Forbush Co. v. Bartley, 78 F. 2d 805 (10th Cir. 1935) (parent's claim denied because based on fraudulent and forged entries).

The first is the problem of adequate capitalization of the subsidiary. Here the question arises whether the advances made to the subsidiary are to be regarded as genuine loans, for which the parent may share as a creditor of the subsidiary, or merely as contributions to the subsidiary's capital, for which the parent's claim must be subordinated to the claims of the subsidiary's creditors. This matter was touched upon above when the question of adequate capitalization of the subsidiary was under discussion.

The second problem concerns the legal incidents which ensue when insolvency has overtaken both the parent and its "adjunct" subsidiary. Here, if the parent's claim is denied, or is subordinated to the claims of the subsidiary's creditors, the latter will benefit at the expense of the parent's creditors. If the parent's claim is allowed, without subordination, its creditors will benefit at the expense of the subsidiary's creditors. The contest is, therefore, really one between the respective creditors of each unit. This problem is considered under the next heading.

E. Competing Equities of Each Unit's Creditors[104]

A difficult problem which arises when the parent corporation and its "adjunct" subsidiary are assimilated concerns the general or unsecured creditors of the two

[104] The Supreme Court's decision in the famous *Deep Rock* case has become, and seems destined to remain, the cynosure in this mattter of the equities of rival claimants in the intercorporate community. Taylor v. Standard Gas Co., 306 U. S. 307 (1939). Here it was found that the subsidiary was under-capitalized and was the victim of mismanagement and spoliation by the parent, and that the affairs of the two units had been commingled. The parent held an enormous claim for advances to the subsidiary. In corporate reorganization procedings under the Bankruptcy Act a plan of reorganization was filed under which the parent's claim was compromised and the subsidiary's nonvoting preferred shareholders received very little. The plan was held to be unfair and judicial confirmation was denied. The parent's claim, it was decided, must be subordinated to the equity of the subsidiary's preferred shareholders. The decision vindicates the prophecy made in Note, *Priority Between Parent Corporation and Preferred Stockholders of Its Bankrupt Subsidiary*, 36 MICH. L. REV. 88 (1937).

Two years later the court rendered another decision to the same effect. Consolidated Rock Co. v. Du Bois, 312 U. S. 510 (1941). Here the court found that the subsidiary had "abdicated" and that the parent had "directly" managed the subsidiary as a "mere department." A plan of corporate reorganization under which the parent's assets were insulated from the claims of the subsidiary's bondholders was, accordingly, held to be unfair, and judicial confirmation was denied. *Accord: Re* Commonwealth Light & Power Co., 141 F. 2d 734 (7th Cir. 1944) (stressing inadequate capitalization of the subsidiary).

In 1948 the Court was asked once again to invoke the Deep Rock doctrine, but refused to do so. Comstock v. Group of Institutional Investors, 335 U. S. 211 (1948). The justices observed that the *Deep Rock* case was based on the particular equities there presented. A majority of them felt that the instant case lacked the equities present in the earlier cases. Four of the justices thought otherwise and dissented vigorously.

Much ink has been spilled over this subject. See Israels, *The Implications and Limitations of the Deep Rock Doctrine*, 42 COL. L. REV. 376 (1942); Krotinger, *The Deep Rock Doctrine: A Realistic Approach to Parent-Subsidiary Law*, 42 COL. L. REV. 1124 (1942); Sprecher, *The Conflict of Equities Under the Deep Rock Doctrine*, 43 COL. L. REV. 336 (1943); Bayne, *The Deep Rock Doctrine Reconsidered*, 19 FORDHAM L. REV. 43, 152 (1950); Note, *The Deep Rock Doctrine: Inexorable Command or Equitable Remedy?*, 47 COL. L. REV. 800 (1947); Note, *Limiting the Deep Rock Doctrine*, 58 YALE L. J. 773 (1949); Note, *Deep Rock Duz Everything*, 29 TEX L. REV. 71 (1950).

The Deep Rock doctrine has been well received and has been much praised. For example, see Krotinger, *supra*, at 1146: "The *Deep Rock* case has the potentiality of setting the law of parent-subsidiary claims on a realistic plane. Even from the meagre line of rulings made since the Supreme Court handed down that decision, it is apparent that the claims of the dominant stockholder in a subsidiary or "one-man" corporation will be more closely scrutinized with a view to setting equitable limitations on

units. Three facets of the problem are revealed. The first is the situation in which the parent corporation is insolvent and the subsidiary is solvent. The second is the situation in which the parent corporation is solvent and the subsidiary is insolvent. The third is the situation in which both the parent and the subsidiary are insolvent.

In the first case (insolvent parent, solvent subsidiary), the assets of the subsidiary are regarded as assets of the parent for purposes of administration.[105] The parent's receiver or trustee in bankruptcy is entitled to take charge of and administer the subsidiary's assets,[106] and creditors of the parent may have a receiver appointed for the subsidiary.[107] The basic qualification is, however, that the rights of the subsidiary's creditors may not be impaired. They are entitled to priority in the subsidiary's assets. Those assets are treated as a separate fund for the benefit of the subsidiary's creditors, and the balance left after satisfying them goes to the parent for the satisfaction of its creditors.[108]

Conversely, in the second case (solvent parent, insolvent subsidiary), the subsidiary's creditors should not be permitted to jeopardize the rights of the parent's creditors.[109]

In the third case (parent and subsidiary both insolvent), the struggle of con-

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the use of the debtor-creditor relationship. It is the writer's belief that we shall see a more discriminating approach to questions of subordination, with a view to a more accurate shaping of the remedy to meet the needs of the individual case." See also Note, 54 HARV. L. REV. 1045, 1051 (1941).

A dissenting voice in the chorus of praise is Bayne, *supra*, at 181, who concludes his elaborate analysis with the comment that "the most prudent and guarded course would be, it is submitted, abandonment of the holding as a doctrine capable of accurate and intelligent application to facts and circumstances in litigation."

[105] *Re* Eilers Music House, 270 Fed. 915 (9th Cir. 1921) (there was apparently "intermingling" of intercorporate affairs here); Day v. Postal Telegraph Co., 66 Md. 354, 7 Atl. 608 (1887) (subsidiary undercapitalized, no separate accounts kept, parent by direct intervention managed property of subsidiary without consulting latter's directors). See *Re* Muncie Pulp Co., 139 Fed. 546 (2d Cir. 1905).

[106] Commerce Trust Co. v. Woodbury, 77 F. 2d 478 (8th Cir. 1935) (subsidiary sales company considered an adjunct or department of the parent because the latter's president "had the power to remove any officer or director of the sales company without consideration or notice, and to dominate and control performance of its contracts"); Central Republic Bank & Trust Co. v. Caldwell, 58 F. 2d 721, 735 (8th Cir. 1932): "We think the relationship existing between the two corporations was of such character and the intermingling of assets so extensive that the trial court was right in directing the bankrupt's receiver to take charge of the whole assets pending further action by the court, and that justice to all parties interested will best be done by such procedure."

[107] Trustees System Co. of Pennsylvania v. Payne, 65 F. 2d 103 (3d Cir. 1933). Here creditors of the insolvent parent, which was in the hands of a receiver, requested the court to appoint receivers for a string of solvent subsidiaries. The court (p. 107) granted the request on the ground that the parent and its subsidiaries "were not merely related by stock ownership but, like wheels in a machine, were so closely meshed that all functioned together" and were "really one company."

[108] Commerce Trust Co. v. Woodbury, 77 F. 2d 478 (8th Cir. 1935). See Simon v. Chambless, 86 F. 2d 569 (5th Cir. 1936). *Cf. Re* Clark Supply Co., Inc., and *Re* Todd Bldg. Corp., 172 F. 2d 248, 254 (7th Cir. 1949).

"Hence, where an instrumentality relationship has been found, the courts have disregarded the subsidiary's corporate entity and allowed the receiver [of the parent] to assume direct control over the assets held by the affiliate as property of the parent." However, "the subsidiary's creditors will be completely protected by according them priority in the assets taken over," whereas "the parent's creditors may benefit from the increment in value resulting from an at least temporary preservation of the system." Note, 46 HARV. L. REV. 823, 827 (1933).

[109] Note, 46 HARV. L. REV. 823, 825 (1933). See Rembar, *Claims Against Affiliated Companies in Reorganization*, 39 COL. L. REV. 907, 912 (1939).

flicting equities reaches its climax. The available authority yields no definitive answer on this specific issue.[110] One possible solution, which might lead to quixotic results if indiscriminately applied, is to lump together the assets of both units and permit the creditors of both units to share this common fund pro rata.[111] Another solution, which would better accord with prevailing concepts in other legal areas, is to assemble the respective assets of the parent and subsidiary into two separate funds and give each set of creditors priority in its particular fund. The parent's creditors receive priority in the parent's assets, and the subsidiary's creditors receive priority in the subsidiary's assets.[112] In the analogous situation when a partnership and the partners are all insolvent, the majority common law rule, the Uniform Partnership Act, and the Bankrupcy Act adopt a similar arrangement whereby the assets are marshaled as follows: The partnership creditors enjoy priority in the partnership assets, and the individual creditors of each partner enjoy priority in that partner's personal assets.[113]

The foregoing principles serve merely as general guides. Their chief virtues are their relative certainty, ease of application, and comparative fairness. It is not humanly possible, of course, to frame a set of rules which can be uniformly applied

[110] See Note, 46 HARV. L. REV. 823, 825 n. 13 (1933). *Cf. Re* Fox West Coast Theatres, 88 F. 2d 212 (9th Cir. 1937). In Henry v. Dolley, 99 F. 2d 94 (10th Cir. 1938), this question was raised by counsel, but the court avoided deciding the issue. In this case the insolvent parent's claim against its insolvent "adjunct" subsidiary was subordinated to the claims of the subsidiary's other creditors. The court said (p. 97): "Counsel for the Telephone Company further assert that it would be inequitable to the creditors of the Telephone Company to subordinate its claim to the claims of other general creditors of the bankrupt. No creditor of the Telephone Company has intervened in the proceeding and there is no showing that the subordination of the Telephone Company's claim would prejudice its creditors. The trustees of the Telephone Company have not asserted that the assets of that company and the bankrupt should be consolidated and the several creditors of the two companies placed on a parity, and that relief has not been sought either by the trustees or by any creditor of the Telephone Company. This being true, we are of the opinion that the claim must be disposed of on a consideration of the rights of the Telephone Company and the creditors of the bankrupt."

[111] ELVIN R. LATTY, SUBSIDIARIES AND AFFILIATED CORPORATIONS 154 (1936): "Perhaps the fairest way of dealing with the situation when both the parent and subsidiary corporations are insolvent is to let all the creditors of each share pro rata in the pooled assets of both. Such procedure would be especially equitable where the claimants are creditors of both the parent and the subsidiary."

[112] A good discussion is found in Note, *The Deep Rock Doctrine: Inexorable Command or Equitable Remedy?*, 47 COL. L. REV. 800, 811 ff. (1947). The writer presents three possible solutions in cases where both units are insolvent and the parent is pressing a claim as creditor for advances to the subsidiary: (1) let the parent share as creditor for the benefit of its creditors; (2) subordinate the parent's claim for the benefit of the subsidiary's creditors; (3) pool the assets of both units and permit all the creditors to share pro rata in the common fund. He then says: "It is possible, and indeed may be necessary, to combine (3) with either (1) or (2) in order to achieve a just solution."

Note, *Parent Corporation's Claim in Bankruptcy of Subsidiary*, 54 HARV. L. REV. 1045, 1050 (1941): "This problem is particularly acute when the parent is also insolvent; the conflict is then between two sets of creditors, both of which may include public investors. .Although the cases have attached little significance to the insolvency of the parent, it might be argued that in such a situation advances up to what would be an adequate capital should be treated, in effect, as capital contributions, and that thereafter claims for which the subsidiary received and retained a fair consideration should be given the status of debts."

[113] Farmers' & Mechanics' National Bank v. Ridge Avenue Bank, 240 U. S. 498 (1916); Rodgers v. Meranda, 7 Ohio 180 (1857); UNIFORM PARTNERSHIP ACT §40(h)(i), 7 U. L. A. §40(h)(i) (1922). *Contra:* Robinson v. Security Co., 87 Conn. 268, 87 Atl. 879 (1913), which applies the "minority common law rule."

with complete fairness to every situation which may arise. This area is, manifestly, one of delicate shadings and refined equities. The elemental wisdom of deciding within the factual framework and individual merits of each case applies with full force. The particular circumstances of a case may well justify or require a departure from a prescribed general scheme of marshaling.

A court, vexed with the difficulty of these problems, may be quick to seize upon a particular circumstance as an equity which favors one group of creditors at the expense of the others. For example, in one case the court allowed the insolvent parent's creditors to share in the insolvent subsidiary's assets together with the subsidiary's creditors, because the latter became creditors with knowledge that the subsidiary was a mere adjunct of the parent.[114] Likewise, another court indicates that under certain circumstances the insolvent subsidiary's creditors may exhaust its assets and then share for the balance of their claims in the insolvent parent's assets together with the parent's creditors.[115] In still another case it appeared that if the assets of parent and subsidiary were segregated, and each unit's creditors were given priority in their respective funds, a grossly unfair distribution would result.[116] Accordingly, the court, in order to permit a more equitable distribution, consolidated the bankruptcy proceedings against the parent and the subsidiary and pooled the assets of both units for pro rata sharing by all the creditors.[117]

[114] New York Trust Co. v. Island Oil & Transport Co., 56 F. 2d 580 (2d Cir. 1932).

[115] See Commerce Trust Co. v. Woodbury, 77 F. 2d 478, 491 (8th Cir. 1935).

[116] Stone v. Eacho, 127 F. 2d 284, 288 (4th Cir. 1942), *cert. denied,* 317 U. S. 635 (1942): "If the Virginia corporation is treated as a separate entity and the property used in the Richmond business is applied to its debts, and the claim of the Delaware corporation is postponed, in accordance with the ruling below, those creditors who have dealt with the Richmond store and have proven claims in the Virginia proceeding, will have their claims practically paid in full, whereas other creditors of the Delaware corporation will receive less than 30% on their claims in the bankruptcy proceeding pending in New Jersey. If on the other hand, the Virginia corporation is treated as a separate entity and the claim of the Delaware corporation is not postponed, this claim will so far absorb the assets at Richmond that other creditors proving in the Virginia proceeding will receive less than half the dividend received by creditors in the New Jersey proceeding. Only by entirely ignoring the separate corporate entity of the Virginia corporation and consolidating the proceedings here with those of the parent corporation in New Jersey can all the creditors receive that equality of treatment which it is the purpose of the bankruptcy act to afford; and this, we think, is the course that should be followed."

[117] Stone v. Eacho, *supra.* The court said (p. 288): "It is too well settled to admit of argument that the claims of a parent corporation against a subsidiary should be thus postponed where the subsidiary, as here, has in reality no separate existence, is not adequately capitalized, and constitutes a mere instrumentality of the parent corporation or a mere 'corporate pocket' or department of its business. . . . And even in the case of the insolvency of both corporations there may be reason for recognizing the separate entity of the subsidiary and postponing the claim of the parent, where the subsidiary has been allowed to transact business as an independent corporation and credit has been extended to it as such on the faith of its ownership of the assets in its possession. LATTY, SUBSIDIARIES AND AFFILIATED CORPORATIONS 153-155. But in a case such as this, where both corporations are insolvent, where the business has been transacted by and the credit extended to the parent corporation, and where the subsidiary has no real existence whatever, there is no reason why the courts should not face the realities of the situation and ignore the subsidiary for all purposes, allowing the creditors of both corporations to share equally in the pooled assets." See Sprecher, *The Conflict of Equities Under the Deep Rock Doctrine,* 43 COL. L. REV. 336, 352 (1943); Krotinger, *The Deep Rock Doctrine: A Realistic Approach to Parent-Subsidiary Law,* 42 COL. L. REV. 1124, 1142 *f.* (1942); Israels, *The Implications and Limitations of the Deep Rock Doctrine,* 42 COL. L. REV. 376, 388, 389, 393 (1942); Rembar, *Claims Against Affiliated Companies in Reorganization,* 39 COL. L. REV. 907, 919 *f.* (1939).

Future action in this arena of legal controversy will, therefore, depend more upon judicial sensitivity to the equities of a case than upon the verbal sweep of general rules.[118]

A similar situation and a decision to the same effect will be found in *Re* Associated Gas & Elec. Co., 149 F. 2d 996 (2d Cir. 1945), *cert. denied,* 326 U. S. 736 (1945), where the court was moved by the desire to protect the subsidiary's, rather than the parent's, creditors.

[118] "Equity looks in all directions. Only in that way can the various interests in the corporate community be adequately protected." Justice Murphy, dissenting, in Comstock v. Group of Institutional Investors, 335 U. S. 211, 238 (1948).

THE AGGRIEVED BUYER OR SELLER OR HOLDER OF SHARES IN A CLOSE CORPORATION UNDER THE S. E. C. STATUTES

Elvin R. Latty*

A person buying or selling or holding shares in a close corporation having, say, half a dozen shareholders may deem himself seriously aggrieved by misrepresentations, half-truths or non-disclosures or by stock sales that dilute his position and yet never pause to consider the prospects for relief that perhaps are offered by the Securities Act of 1933,[1] hereafter called the Securities Act, or the Securities Exchange Act of 1934,[2] hereafter called the Exchange Act. His lawyer in all probability has had little occasion to familiarize himself with that legislation. To one who has not followed some of the developments within the past few years, those statutes are thought of as an attempt to deal solely with "public issues" of securities and the practices of promoters, underwriters, stock brokers and dealers, stock market manipulators, and similar players in the game of high and low finance whose doings affect the stock exchanges or at any rate the investing "public." All this legislation, he suspects, has nothing to do with a private fight between John Doe and Richard Roe involving the issue or sale of some shares in the local Doe-Roe, Inc., which owns and operates a department store on Main Street.

Well, he may eventually turn out to be right. The Supreme Court has not spoken yet on the reach of federal law into this close corporation area and the extent of that reach is not beyond controversy. Meanwhile, the doctrines that the lower federal courts have been developing cannot be overlooked. To illustrate:

The Slavins (two brothers) owned one-half of the stock of two affiliated corporations. The Kardons (father and son) owned the other half. The Slavins, unknown to the Kardons, made a deal to sell the corporate properties to certain outside interests for $1,500,000, plus certain additional benefits. Then, without disclosing this deal, the Slavins bought out the Kardons for $504,000. When the Kardons found this out, they brought this action in the federal court against the Slavins, alleging these facts as violations of the Exchange Act, Section 10(b), and of the SEC Rule under that Act, Rule X-10B-5, to make the Slavins account for the profits made by them through the sale of those corporate assets.[3] The Kardons were successful, both

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[1] 48 Stat. 74 (1933), as amended, 15 U. S. C. §77a *et seq.* (1946). This Act will be cited hereafter in text and footnotes by section number only.

[2] 48 Stat. 881 (1934), as amended, 15 U. S. C. §78a *et seq.* (1946). This Act will be cited hereafter in text and footnotes by section number only.

[3] A request in the prayer for relief against the outside purchaser, National Gypsum Co., was abandoned by stipulation.

on the defendants' motion to dismiss the complaint for failure to state a cause of actions[4] and on the merits.[5]

The point that stands out in that case, at this stage of our discussion, is that here was a federal law reaching into a purely private fight between the two families of a close corporation over a sale of shares in that corporation involving no kind of organized "market" and nothing remotely resembling "public investors" or public solicitation to buy or sell.

Although the question whether the Exchange Act was meant to apply only to securities traded on a national exchange or in the over-the-counter market maintained by brokers and dealers may not have been expressly raised in the *Kardon* case,[6] later cases have expressly recognized the point. Except for one unreported District Court case,[7] later reversed on this point, the decisions have held that this federal legislation reaches even such "private" transactions.[8]

LIABILITY PROVISIONS PERTINENT TO DEALS IN CLOSE CORPORATIONS

The specific sections of this federal legislation which will ordinarily be invoked in a grievance relating to shares in a close corporation boil down to just about two sections giving rise to civil liability:[9] Section 12(2) of the Securities Act and Section 10(b) of the Exchange Act as implemented by the SEC's Rule X-10B-5.

The other civil liability sections of this legislation will in general be inapplicable to deals in shares of a close corporation. Thus, Section 12(1) of the Securities Act will not come into play for that section imposes civil liability only for a sale in violation of Section 5—that is, a sale of an *unregistered* security which is by that Act required to be registered or a sale of a *registered* security without a proper prospectus. By virtue of express exemptions, there is no requirement for the registering (and hence there will be no registering) of a security that is sold by "any person other than an issuer, underwriter or dealer" or that is sold even by an issuer if the transaction is one "not involving any public offering."[10] The quoted words will exempt from registration just about any deal involving shares of a close corporation, even a new "issue" sold by that corporation in raising additional capital from erstwhile outsiders, so long as in the process of finding the contributing capitalist (we may almost call him the incoming partner) the corporation does not advertise generally and does not solicit so many persons as to make a "public" offering.[11] For similar

[4] Kardon v. National Gypsum Co., 69 F. Supp. 512 (E. D. Pa. 1946).

[5] Kardon v. National Gypsum Co., 73 F. Supp. 798 (E. D. Pa. 1947); same, on request for further findings of fact, 83 F. Supp. 613 (E. D. Pa. 1947).

[6] See remarks of Grim, J., in Robinson v. Difford, 92 F. Supp. 145, 149 n. 6 (E. D. Pa. 1950).

[7] Fratt v. Robinson, D. C. Wash. July 31, 1951, No. 2765, *rev'd*, 203 F. 2d 627 (9th Cir. 1953).

[8] Northern Trust Co. v. Essaness Theatres Corp., 103 Supp. 954 (N. D. Ill. 1952); Robinson v. Difford, *supra* note 6, noted 64 HARV. L. REV. 1018 (1951). See also Speed v. Transamerica Corp., 99 F. Supp. 808, 830 (D. Del. 1951), on merits, motion for summary judgment for the defendant having been previously denied, 71 F. Supp. 457 (D. Del. 1947).

[9] The provisions under discussion also give rise to criminal liability, as does the federal mail frauds statute, 18 U. S. C. §1341 (1946 ed. Supp. V). The possibility of administrative or injunctive action by the SEC can just about be eliminated in a discussion of close corporations.

[10] Securities Act, §4(1), relating to exempt transactions.

[11] See Sec. Act Rel. No. 285 (Jan. 24, 1935), CCH FED. SEC. LAW SERV. ¶2266.17 (opinion of Gen-

reasons, the much discussed liability under Section 11 of the Securities Act does not touch the close corporation situation, since that liability is for misstatements and omissions in the Registration Statement, a document which does not make its appearance in the case of close corporations. The only other section in the Securities Act that could be the basis of liability, Section 17(a),[12] is so identical in wording with Rule X-10B-5 that it had better be considered in the later discussion of that Rule.

The irrelevance to the close corporation of certain private-remedy sections is also true of the Exchange Act. Section 9(e) of that Act imposes liability for designated practices with respect to *listed* securities. Section 16, imposing liability on insiders for "short swing" profits also applies only to *listed* securities. Section 18 imposes liability for making false or misleading statements in certain documents filed under the Exchange Act but, here again, close corporations make no such filings.

We return, then, to the sections pertinent to the close corporation situation. Since the technical pattern of these sections is so crucial to the discussion that follows, that discussion is incomprehensible unless we have before us the exact language of those sections.

[Securities Act]. Section 12. Any person who . . .

(2) sells a security [whether or not exempted from registration] by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

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eral Counsel of SEC). Despite the rejection in that opinion of the number 25 as a rule of thumb for establishing the "private offering" exemptions, it is quite probable that the solicitation of that small a number of offerees with whom the shares could reasonably be expected to "come to rest" (not acquired simply as a step in further resales), would not require registration of the security under the Securities Act, particularly if the solicitation is among the friends, relatives, and acquaintances of the management. See Campbell v. Degenther, 97 F. Supp. 975 (W. D. Pa. 1951) (no registration required where defendant sold 32 shares among friends and persons introduced through mutual business acquaintances). There is even a suggestion in the case last cited that the amount offered for sale may be so small (in that case about $4000) that it cannot be construed as a "public issue." That may be an overstatement. See also Siebenthaler v. Aircraft Accessories Corp. (unreported), CCH FED. SEC. LAW. SERV. ¶90,122 (W. D. Mo. 1940) (an offering to three shareholders of another corporation). The SEC's contention that an offering is still a public offering and is not exempt simply because made only to "key employees" was upheld in SEC v. Ralston Purina Co., 346 U. S. 119 (1953); it may be noted that the offering in question was to several hundred employees, including those with duties of clerical assistant, copywriter, electrician, stock clerk, office clerk, order credit trainee, and stenographer.

[12] There is a remote possibility that the "anti-touting" provisions of §17(b) of the Securities Act might be involved in a sale of shares in a close corporation if the shares are sold by a "dealer," but the likelihood is so remote as to justify no more than this brief footnote reference.

The only observations about this Section that need be made at this point are that: (1) it reaches even sales of exempt securities, with an exception irrelevant to this discussion; (2) it protects buyers against sellers, not vice versa; and (3) it hits at untruths and half truths in statements, rather than "pure" non-disclosures. We may add that the liability is subject to a short period of limitations: one year after discovery has been made or should have been made by the exercise of reasonable diligence; and in any event no more than 3 years after the sale[13]—the so-called one-and-three period.

The other pertinent provision is a rule promulgated by the SEC, based upon the statutory authorization in Section 10(b) of the Exchange Act,[14] as follows:[15]

Rule X-10B-5. Employment of Manipulative and Deceptive Devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(a) to employ any device, scheme, or artifice to defraud,

(b) to make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

In choosing the language for the above Rule X-10B-5, the SEC took as its model the words of Section 17(a) of the Securities Act, of some nine years before, which deserves to be reproduced here because of its own independent importance as well as for the light which it sheds on Rule X-10B-5:

[Securities Act] Section 17. (a) It shall be unlawful for any person in the sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

One observes that Rule X-10B-5 seems to cover everything that falls within Sections 12(2) and 17(a) of the Securities Act; not only does it hit at both the wrongdoing seller and the wrongdoing buyer (unlike the Securities Act sections) but its clause

[13] Securities Act, §13.

[14] [Exchange Act] "Sec. 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange. . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

[15] 17 Code Fed. Regs. §240.10b-5 (1949).

(2) may itself take in all of Section 12(2), leaving clauses (1) and (3) as further expansions of even a buyer's cause of action. The awkwardness of this statutory structure gives rise to a perplexing problem, as we shall see.

There is one further provision that might give rise to a private cause of action in the close corporation deal. It is conceivable that the buyer or seller of shares in a close corporation might resort to a broker[16] to negotiate the deal, or that the holder of such shares might even sell to a dealer[17] who in turn resells. Such might be the case, for instance, if the buyer is an insider who wants to conceal his identity from the selling shareholder or if the insider wants to sell out and prefers to have the purchase-inducing misrepresentations made by the intermediary. For misdeeds of the broker or dealer in such a transaction the aggrieved seller or buyer could, in addition to Rule X-10B-5, invoke against the broker or dealer Section 15(c)(1) of the Exchange Act, which provides that

> No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security . . . [off a national securities exchange] by means of any manipulative, deceptive or other fraudulent device or contrivance . . .[18]

Further consideration of the above Section (together with the Rule thereunder) will be excluded from this discussion, both because of the remoteness of its application to the close corporation and because of the co-extensive reach of Rule X-10B-5 which addresses its similarly worded proscriptions to "any person in connection with" a sale or purchase of a security and is accordingly broad enough to include brokers.[19] One notes, then, that even in a close corporation deal there can be overlappings of various sections in the Securities Act and the Exchange Act; thus, in the rather improbable case where a broker is involved in a close corporation deal, his proscribed doings prejudicing a *buyer* can at the same time be a violation of the Securities Act Section 17(a), the Securities Act Section 12(2)[20] and the Exchange Act Section 15(c)(1), not to speak of the long arm of X-10B-5.

THE BASIS OF THE FEDERAL REACH INTO "PRIVATE" DEALS—THE CLOSE CORPORATION

The case for the extension of the federal laws into such a private deal as that involved in the *Kardon* case rests primarily on the literal language of the above quoted sections. They proscribe malpractices in any "sale" and in any "purchase or sale." It is to be noted, say the proponents of such extension, that sale or purchase is not

[16] *I.e.*, one engaged in the business of effecting transactions in securities for the account of others. Exchange Act §3(4).

[17] *I.e.*, one engaged in the business of buying or selling securities for his own account. Exchange Act §3(5).

[18] This Section has been implemented by SEC rules defining the "devices or contrivances" that are to be included within the designation "manipulative, deceptive or otherwise fraudulent." Rule X-15C1-2, 17 CODE FED. REGS. §240.15c1-2 (1949).

[19] In the Matter of Van Alstyne, Noel & Co., Exch. Act Rel. No. 4699, April 8, 1952, CCH FED. SEC. LAW SERV. ¶76,110; In the matter of M. S. Wien & Co., Exch. Act Rel. No. 3855, Sept. 17, 1946, CCH FED. SEC. LAW SERV. ¶75,700. We pass over the question whether, under §29 of the Exchange Act, an X-10B-5 action may have a longer period of limitations than a §15(c)(1) action.

[20] Cady v. Murphy, 113 F. 2d 988 (1st Cir. 1940).

defined as, or otherwise expressly limited to, transactions upon the stock exchanges or in other marts of the professionals; indeed, Section 10(b) of the Exchange Act, on which Rule X-10B-5 is based, expressly includes sales and purchases of a security ***not registered*** on any exchange.

But, argues the opponent of extension, who concedes that the lower federal courts are largely against him,[21] an aggrieved seller (unlike a buyer), has to base himself on the Exchange Act (and not on the Securities Act), and the Exchange Act's very purpose is to cope with stock-market and over-the-counter evils, as is revealed even by the following preamble (in part) of Section 2 of that Act, not to speak of the rest of that Section:

> Section 2. For the reasons hereinafter enumerated, transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, including transactions by officers, directors, and principal security holders, to require appropriate reports, and to impose requirements necessary to make such regulation and control reasonably complete and effective, in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets in such transactions. . . .

So, continues the opponent of extension, although Section 10(b) expressly includes securities not registered on any stock exchange, that still means that the scope of the Act does not extend beyond stock exchanges and *over-the-counter markets.*

But, says the proponent of extension, the "over-the-counter market" means the whole wide world; any deal off the stock exchange is over-the-counter. He can find support.[22] To this writer, this particular argument of the proponents seems far fetched. "Over-the-counter" is a strange term if all you mean is off the stock exchanges.[23] Certainly the sections of the Exchange Act relating to the over-the-counter market show that those sections at least are concerned with the doings of professionals,[24] not with deals between two quasi-partners over their holdings in an incorporated partnership.[25]

The opponent of extension will also contend (soundly, in this writer's view) that the reference in the above-quoted Section 2 of the Exchange Act to officers, directors, and principal security holders does not necessarily mean to include sales or pur-

[21] Cases cited *supra* notes 4, 5, 6, and 8; *cf.* Fratt v. Robinson in the District Court, *supra* note 7.

[22] In legislative history: H. R. REP. No. 2307, 75th Cong. 3d Sess. 2 (1938): "Under the Securities Exchange Act of 1934, the over-the-counter markets are deemed to include all transactions in securities which take place otherwise than upon a national securities exchange." This quotation, however, is not necessarily inconsistent with a limitation to professional trading channels. See LOSS, SECURITIES REGULATION 709 (1951); Comment, 59 YALE L. J. 1120, 1140 n. 95 (1950).

[23] See Fratt v. Robinson, 203 F. 2d 627 (9th Cir. 1953).

[24] *E.g.*, §§15 and 15A of the Exchange Act, being elaborate provisions for control (including self-policing) of brokers and dealers.

[25] See Recent Cases, 64 HARV. L. REV. 1018, 1019 (1951); *cf.* CCH FED. SEC. LAW SERV. ¶22,971.01: "'Over-the-counter market' as used in this bill refers to a market maintained off a regular exchange by one or more dealers or brokers. . . ." (Mr. Rayburn, 78 CONG. REC. 7700 April 30, 1934).

chases by insiders in close corporations; that reference still can reasonably relate to organized markets and serve, for instance, to anticipate the insider's liability for "short swing profits" in listed securities under Section 16(b) of the Exchange Act.

A better argument for extension of this legislation beyond the "markets" is that the preamble of a statute is not to be relied upon to change fairly plain and unambiguous provisions,[26] particularly when it would be quite natural for a preamble in a statute aimed at malpractices to single out for mention only those more crucial areas in which the malpractices occur.

Moreover, contends the proponent of extension, certainly in the other statute, the Securities Act, there is nothing (in preamble or elsewhere) that excludes a private deal from its coverage. Quite the contrary: Section 17(a) of that Act applies even to exempt securities, by an express provision to that effect,[27] and regardless of whether the transaction in question is so "private" as to fall within the exemption (already noted) from the registration requirements of that Act.[28] (Also, nothing in the language of Section 12(2), above quoted, suggests that any "private" deal is beyond the reach of that Section.) It would be illogical, on the strength of an ambiguous phrase in the preamble of the Exchange Act, to restrict the reach of X-10B-5 under that Act to "public" transactions when it is so obvious that the language used in X-10B-5 is identical to that of Section 17(a), which in turn covers even private deals.

Furthermore, Section 10(b) perhaps shows on its face an intention to go beyond the "public interest" mentioned in the preamble, for Section 10(b)'s mandate to the SEC is to "prescribe rules and regulations necessary or appropriate in the public interest *or for the protection of investors.*" (Italics supplied.) Judge Kirkpatrick in the *Kardon* case apparently took the position that one is an "investor" within the meaning of that section even if he is half owner of a close corporation;[29] and the latest judicial pronouncement is to the effect that, although in general the Exchange Act is directed at transactions involving professional handlers of security transfers, Sec. 10(b) aims to go further, else there would be an incentive for crooked deals to by-pass the organized markets.[30]

Finally, say the proponents of extension, both the Securities Act and the Exchange Act define "security"[31] so as to include a list of things that do not lend themselves to trading in markets, including "investment contracts" which in turn may be pro-

[26] See Yazoo & Mississippi Valley R. R. v. Thomas, 132 U. S. 174, 188 (1889); 2 SUTHERLAND, STATUTES AND STATUTORY CONSTRUCTION §4820 (3d ed., Horack, 1943); CRAWFORD, STATUTORY CONSTRUCTION §205 (1940).

[27] Securities Act §17(c): "The exemptions provided in section 3 shall not apply to the provisions of this section." Section 3 of the Securities Act enumerates the securities that are exempt from most provisions of that Act.

[28] By §4(1) of the Securities Act "transactions by an issuer not involving any public offering," as well as "transactions by any person other than an issuer, underwriter or dealer" enjoy an exemption, true, but that exemption is only from the provisions of §5, which in turn deals only with requirements with respect to registration of a security and to prospectuses.

[29] See Kardon v. National Gypsum Co., *supra* note 4, at 514.

[30] See Fratt v. Robinson, 203 F. 2d 627 (9th Cir. 1953).

[31] Securities Act, §2(1); Exchange Act §3(10); See Comment, 59 YALE L. J. 1120, 1140 n. 95 (1950).

motional schemes disguised in the lamb's clothing of a mere land-purchase contract.[32] Many of the "Ponzi," "switch," and "front money" schemes[33] involved in criminal prosecutions presumably could be violations of X-10B-5 as well as of Section 17(a), although they do not involve the type of "security" one expects to find traded in the professionals' "market."[34]

It would seem, on the whole, that the scheme of these statutes is to reach all sales and purchases of securities, as a general approach, and then to make express exemption of specific situations where such exemption is intended. One may venture a prediction that the upper courts will uphold the extension of X-10B-5 into deals involving transfers of shares in close corporations. But the opponent of such extension might suceed in one further last ditch stand: this federal legislation should not be interpreted so as to concern itself with transactions which involve neither the organized exchange nor the over-the-counter markets maintained by professionals nor the danger of resort to private deals in order to by-pass the federal legislation nor a scheme to buy from or sell to a sufficiently substantial circle of persons so as to warrant more than mere local state-law concern. This reasoning rests more on general considerations relating to our system of dual sovereignty, even aside from any constitutional question. In the eventual decisions of the upper courts, much may depend on the temper of the times and on the swing of the pendulum between leanings toward centralization or toward decentralization.

It may also be worthy of note that the SEC interprets X-10B-5 as reaching into close corporations, which in turn may have some effect on judicial interpretation in the same direction.[35]

THE PARADOX OF THE "IMPLIED" CIVIL LIABILITY PROVISIONS, ESPECIALLY X-10B-5

No express mention of any civil liability of the violator in favor of the aggrieved party is made by X-10B-5 or Section 17(a) of the Securities Act or Section 15(c)(1) of the Exchange Act. Those sections are on their face simply "thou shalt not" pronouncements. One might contend that violations of these provisions were intended to be subjected only to criminal liability and to the regulatory sanctions administered by the SEC. Nevertheless, X-10B-5 in particular has been held by the courts to impose civil liability by implication,[36] although there is more doubt as to whether

[32] For a criminal conviction for violation of §17(a) of the Securities Act in the sale of such a "security," see United States v. Earnhardt, 153 F. 2d 472 (7th Cir. 1946).

[33] 10 SEC ANN. REP. 144 ff. (1944).

[34] *E.g.*, the fraud on members of a club in United States v. Monjar, 147 F.2d 916 (3d Cir. 1944).

[35] See Northern Trust Co. v. Essaness Theatres Corp., 103 F. Supp. 954, 961 (N. D. Ill. 1952).

[36] In addition to cases cited *supra* notes 4-8 inc., the reported cases include: Fischman v. Raytheon Mfg. Co., 188 F. 2d 783 (2d Cir. 1951); Slavin v. Germantown Fire Ins. Co., 174 F. 2d 799 (3d Cir. 1948); Osborne v. Mallory, 86 F. Supp. 869 (S. D. N. Y. 1949); Fry v. Schumaker, 83 F. Supp. 476 (E. D. Pa. 1947); see also Acker v. Schulte, 74 F. Supp. 683 (S. D. N. Y. 1947). The doctrine has been recognized in cases where, for other reasons, the plaintiff was unsuccessful: Joseph v. Farnsworth Radio & Television Corp., 198 F. 2d 883 (2d Cir. 1952), *aff'g* 99 F. Supp. 701 (S. D. N. Y. 1951); Birnbaum v. Newport Steel Corp., 193 F. 2d 461 (2d Cir. 1952). There are many unreported cases, to the same effect, mentioned in LOSS, SECURITIES REGULATION 827 n. 62 (1951). Loss states (*id.* at 1049) that the *Kardon* case "has since been followed in almost two score other cases by seven other District Courts, almost all of them under Rule X-10B-5."

this is true in favor of an aggrieved buyer, as will be seen in a moment. Indeed, the implied liability aspect of the *Kardon* case, which was the first judicial recognition of this liability, caused much more of a stir in legal circles than did the close corporation aspect of the transaction there involved. One theory upon which the decisions rest is the common law tort doctrine recognizing a private action in favor of those persons whose interests are intended to be protected by a statute even though the statute may express only a criminal sanction.[37] Another theory is that Section 29(b) of the Exchange Act not only expressly makes contracts that violate the Act "void"[38] but also was amended[39] so as to impose a short period of limitation in *private* actions for violation of any rule under Section 15(c)(1), a Section which is equally silent about civil liability; all of which seems, therefore, to recognize an implied liability theory.[40] Although such "voidness" might understandably be deemed sufficient for rescission, it has been said to be also sufficient for a cause of action for money damages under one of these "silent" sections.[41]

This judicial creation of an "implied" civil liability brings up a statutory paradox. To spotlight this paradox we shall have to refer, however briefly, to some statutory provisions beyond those applicable to close corporations.

By its *express* civil liability provisions, the Securities Act carefully lays out the rights and remedies of an aggrieved *buyer*, as well as the deliberate limitations thereon. Thus, if one acquires a registered security with respect to which an effective registration statement contains material misstatements or omissions, he has, under the famed Section 11 of the Securities Act, a cause of action against a formidable array of persons (signers, directors, experts, underwriters, issuer, etc.), all with careful and intricate provisions (which would just about fill three of these pages) relative to privity, reliance, scienter, burden of proof of specific issues under detailed variations, standards of reasonableness, amount of recovery, indemnity for costs and fees in litigation. By Section 12(1) of the Securities Act one who buys a security that ought to have been but has not been *registered*, or buys a *registered* security without being given the required prospectus, has rights against his immediate seller, again with certain limitations. Finally, Section 12(2) of the Securities Act, quoted in previous pages, protects, but again with certain restrictions, the buyer who is sold by untruths and half-truths. It is arguable, therefore, that the express liability sections were meant to set forth the *only* rights of the buyer not only with respect to certain malpractices in special circumstances, as in Sections 11 and 12(1) of the Securities Act, but also as to the general area of misrepresentations which induce purchases and which prejudice the buyer. (However, one might point out that this legislative

[37] RESTATEMENT TORTS, §§286-288; Morris, *The Relation of Criminal Statutes to Tort Liability*, 46 HARV. L. REV. 453 (1933); Lowndes, *Civil Liability Created by Criminal Legislation*, 16 MINN. L. REV. 361 (1932).

[38] Both theories were invoked by the court in the *Kardon* case, *supra* note 4.

[39] Public Act No. 719, §3, 75th Cong., 3d Sess. (1938).

[40] See Comment, 59 YALE L. J. 1120, 1134 (1950).

[41] See Geismar v. Bond & Goodwin, Inc., 40 F. Supp. 876, 878 (S. D. N. Y. 1941).

pattern still leaves gaps even as to buyer-plaintiffs, *e.g.*, liability of a fraudulent accountant in a close corporation deal—hence not within Sections 11 or 12.)

Into this neat statutory scheme bursts X-10B-5 purporting to redress all grievances in the securities field, giving causes of actions to everybody, buyer and seller alike, and for all bad deeds—and by implication at that. There is hardly a misdeed proscribed by Sections 11 or 12 of the Security Act (or by various sections of the Exchange Act) that could not be brought within the language of X-10B-5. What now, then, of all that care taken in the Securities Act for the more restricted protection of buyers? Shall X-10B-5 be, therefore, limited to the protection of sellers? But its very language expressly covers both purchases and sales. And if, despite its inclusion of both, it were to be construed to give a private remedy only to aggrieved *sellers,* such sellers would be better off than aggrieved buyers, who, it is recalled, are hemmed in by many restrictions in their recoveries under the express liability sections. The implied liability of the *Kardon* doctrine under X-10B-5 creates a paradox however one views X-10B-5; the courts' dilemma is well put by Loss:[42]

> Should they permit buyers to sue under X-10B-5 and thus ignore the safeguards which Congress chose to throw around buyers' actions in Sections 11 and 12? Or should they restrict the *Kardon* doctrine to suits by sellers (or at any rate, non-buyers) and thus treat the seller stepchild far better than the buyer favorite son—not to mention the fact that any discrimination between seller and buyer would fly in the face of Section 10(b) and the rule [Rule X-10B-5].

Small wonder, then, that the courts have disagreed on the way out of the dilemma. Some of the federal district courts limit the *Kardon* doctrine of implied civil liability to *sellers,* on the theory that the *statutory* remedy for *buyers,* at least in the area of misrepresentations in the sale (whether by untruths, half-truths or otherwise), is carefully, specifically, and expressly set out in these Acts, particularly in Sections 11 and 12 of the Securities Act.[43] By that view the rights of a buyer of shares in a close corporation against his seller under this federal legislation would be worked out solely through Section 12(2), with all its limitations. (Except perhaps where the seller is a broker or dealer, under Section 15(c)(1) of the Exchange Act, above discussed. Liability under that Section has a short period of limitations.)[44] Even that view would not bar an X-10B-5 action by a buyer against some third party culprit, *e.g.*, an accountant preparing false statements.

On the other hand, other federal courts, including the only Court of Appeals that has passed on the point as of this writing, view the X-10B-5 implied liability as applying even in favor of buyers against sellers.[45] One case suggests that perhaps

[42] Loss, SECURITIES REGULATION 1055 (1951).

[43] Rosenberg v. Globe Aircraft Corp., 80 F. Supp. 123 (E. D. Pa. 1948); Montague v. Electronic Corp. of America, 76 F. Supp. 933 (S. D. N. Y. 1948); and see Fischman v. Raytheon Mfg. Co., 9 F. R. D. 707 (S. D. N. Y. 1949), *rev'd* 188 F. 2d 783 (2d Cir. 1951).

[44] Exchange Act, §29(b).

[45] Fischman v. Raytheon Mfg. Co., 188 F. 2d 783 (2d Cir. 1951), *rev'g* 9 F. R. D. 707 (S. D. N. Y. 1949); Osborne v. Mallory, 86 F. Supp. 869 (S. D. N. Y. 1949). See also Frank, J. (dissenting on another point) in Joseph v. Farnsworth Radio & Television Corp., 198 F. 2d 883 (2d Cir. 1952).

this is true only if the buyer's grievance rests on the buyer's "proof of fraud" over and above the proof that he needs to make out a buyer's cause of action under the express civil liability sections.[46] That case perhaps can be viewed as an attempt to fit Rule X-10B-5 and the mandate in its statutory source, Section 10(b), to regulate both sales and purchases, into the statutory scheme for buyers along these lines: so long as the buyer claims the benefit of the proof-burdens put upon the seller or of the scienter-dilution under the express liability sections, he is subject to the restrictions in those sections; if he is willing to take on the burden of proof (especially, proof of seller's knowledge of falsity of the statements in question), then the buyer can use X-10B-5. This line of reasoning is perhaps also applicable to the use of Section 17(a) as a basis of implied liability in favor of the buyer, if one does not mind magnifying the paradox.[47]

If one were to harmonize the *buyer's* remedies under X-10B-5 with the careful express liability provisions by construing X-10B-5 as applying only to those statutory provisions tailored specifically to the practices and malpractices of security trading for which no express liability is mentioned, that would limit the buyer's use of X-10B-5 to certain situations under the Exchange Act, rarely applicable to the close corporation picture. (*E.g.*, purchase by a customer of securities induced by a broker who does not reveal, in violation of Rule X-15C1-5,[48] that he controls the issuer[49]—which in the rare case might involve a block of stock in a close corporation.) The most recent judicial pronouncement (as of this writing) is a thesis by Judge Frank apparently to the effect that the subsequent overlapping by X-10B-5 of previous specific sections creating liability-with-restrictions is a determination by the SEC, valid under the authorization of Section 10(b), that the SEC did not deem it "necessary or appropriate" (in the language of said Section) to require those restrictions in *any* X-10B-5 liability, whether overlapping or not.[50]

In all probability, whatever happens to the buyer, the *seller's* private remedy under X-10B-5 seems fairly well entrenched.[51]

USE OF MEANS OR INSTRUMENTALITIES OF INTERSTATE COMMERCE OR MAILS

By their express provisions, traceable in turn to the limited powers of Congress,

[46] See Frank, J., in Fischman v. Raytheon Mfg. Co., *supra* note 43, at 786-787. In Judge Frank's remark that "proof of fraud is required in suits under . . . Rule X-10B-5," he probably did not mean that "fraud" (with whatever its scienter requirement may be) must always be established under Rule X-10B-5, for it would appear that under paragraph (b) of the Rule (the paragraph relating to untruths and non-disclosures), no greater degree of "fraud" is necessary than in, say, a §12(2) case under the Securities Act. It is more likely that he meant that under X-10B-5 the buyer plaintiff must carry the burden of proof of establishing that the truth is otherwise than as was stated or half-stated by the defendant.

[47] In Fischman v. Raytheon Mfg. Co., *supra* note 43, at 787 n. 2, §17(a) was included in passing with X-10B-5 as creating implied liability in favor of the *buyer*. See criticism by Loss, SECURITIES REGULATION 1060 (1951).

[48] 17 CODE FED. REGS. §240.15C1-5 (1949).

[49] See Loss, SECURITIES REGULATION 1063 (1951). Loss's entire discussion of the point under consideration is an excellent analysis, pp. 1054-1065.

[50] Joseph v. Farnsworth Radio & Television Corp., 198 F. 2d 883, 887 (2d Cir. 1952) (in a dissent by Judge Frank on another point).

[51] See cases cited *supra* note 36, and cross reference therein.

these federal statutes do not apply to a transaction in which, to do the proscribed act, no use is made of the "mails" or of "any means or instrumentality of interstate commerce."[52] (In this discussion of close corporations, we can disregard the use of "any facility of any national securities exchange," a basis of jurisdiction mentioned in the Exchange Act.) Those are the words used in the Exchange Act and in Rule X-10B-5; in the Securities Act, the words used, besides "mails," are "any means or instruments of transportation or communication in interstate commerce."[53] It is doubtful that the difference in language is anything more than an attempt in the later Act to find a less awkward phrase than that used in the earlier Act. There exist other minor differences in statutory language relating to the use of federal channels.[54]

It is conceivable that a transaction relating to shares in a close corporation might avoid these federal channels. To put a rather strong illustration: Seller *A*, living and having his office in city *X*, sells his holdings in a close corporation to buyer *B* of the same city; all the negotiations are held in *A*'s office; to attend these conferences neither *A* nor *B*, nor any significant representative of theirs, uses an interstate train, bus or plane, not even between points within the state; there is no use of the mails, nor is an interstate phone-call made, not even to make the appointments; delivery of the securities is made by *A* handing them over to *B* in *A*'s office; *B* pays by handing over his check on a local bank[55] and walks out with the securities. In such a case the aggrieved party may have to look to local law for redress; the federal statutes would seem inapplicable.

But suppose that after making the oral contract of sale and receiving payment, all in face-to-face dealing, the seller mails the securities to the buyer or makes delivery by transporting them across state lines? By the view taken by some courts in construing Section 12(2) of the Securities Act, in civil liability cases based on that Section, the Act would not be violated because the misleading *statements* were not transmitted through the designated facilities,[56] *i.e.*, mails, or facilities of interstate communication or transportation. By that view, if the only communications are oral, it would take the use of interstate telephone or radio to make that Section

[52] Exchange Act, §10(b), *supra* p. 508; §15(c)(1), *supra* p. 509.

[53] Securities Act, §§12(2), 17(a), *supra* pp. 507, 508.

[54] To do certain acts "by the use of" the designated interstate facilities is what is forbidden by some provisions, including those in X-10B-5; other sections forbid "to make use of" those facilities to do the forbidden act. One dares not predict whether courts will find differences between this Tweedle-dee and Tweedle-dum.

[55] A "local bank" has been used in this illustration out of excess of caution. Whether the use of the mails in clearing an out-of-town check would bring the transaction within these statutes is another question. See note 64 *infra*.

[56] Kemper v. Lohnes, 173 F. 2d 44 (7th Cir. 1949); Siebenthaler v. Aircraft Accessories Corp. (unreported), CCH FED. SEC. LAW SERV. ¶90,122 (W. D. Mo. 1940) (not clear whether the point was really essential to the decision.)

Dicta dropped *en passant* can be found to the same effect in Independence Shares Corp., v. Deckert, 108 F. 2d 51, 54 (3d Cir. 1939); Murphy v. Cady, 30 F. Supp. 466, 469 (D. Me. 1939).

Cf. Gross v. Independence Shares Corp., 36 F. Supp. 541 (E. D. Pa. 1941), announcing a different theory why the mere delivery through the designated facilities does not incur liability under §12. See *infra*, text to note 75.

applicable. If that view is precluded by the slightly different language of X-10B-5, as has been judicially recognized[57] that again would bring up the paradox problem if a *buyer* seeks to sue under those provisions. Admittedly, that is one possible interpretation of that awkward phrase in Section 12(2): "any person who . . . sells a security . . . by the use of any means or instruments of transportation or communication in interstate commerce . . . by means of a prospectus or oral communication."

As against this narrow interpretation another equally possible and perhaps more plausible interpretation is that the civil liability of Section 12(2) applies whenever misleading written or oral statements are made in the sale of a security, regardless of the channels through which they are made, provided that the sale *otherwise* involves the use of the designated federal channels, at least by the seller. Accordingly it has been held that the civil liability imposed by Section 12(2) applies even though the mails[58] or interstate transportation facilities[59] are not used until making delivery of the security after the contract of sale. This broad interpretation is more consistent with the purpose of the Act and with its terminology, in the light of the doctrine that the Federal Government is one of delegated specific powers, not one of general powers—a doctrine which time and again accounts for the strange structure of federal legislation. The federal securities legislation was enacted as an attempt at regulation of securities transactions because regulation by the states was either non-existent, ineffective or circumvented by dealings across state lines, particularly from an operational base in a state without blue sky laws.[60] If Congress had *general* legislative power, it is fair to assume that the mails-and-interstate-facilities element would never have appeared in the legislation; instead, we would have had a plain statement: he who sells by lies and half-truths is liable. The reference in the legislation under discussion to mails and interstate facilities should be viewed not as making lie-transmission through those channels the gist of the offense but rather, as hitting at all sales by the forbidden misrepresentations, non-disclosures, and schemes in transactions within the reach of the federal power that is brought into play by the use of the mails and interstate facilities. To adopt the narrow view would open the field again for the sharp promoter: he could cover the country with "talking agents" or see to it that they are supplied with locally printed prospectuses. The only decision upholding the narrow view of the requirement of the use of mails and interstate facilities which purports to give the problem anything resembling a considered analysis contains, with all due respect, only question-begging reasoning in its support.[61] Incidentally, the contrary broad view seems to be supported by the legal writers.[62]

[57] Fratt v. Robinson, 203 F. 2d 627 (9th Cir. 1953).

[58] Schillner v. H. Vaughan Clarke & Co., 134 F. 2d 875 (2d Cir. 1943).

[59] Moore v. Gorman, 75 F. Supp. 453 (S. D. N. Y. 1948) (delivery by messenger by train from Philadelphia to New York).

[60] As in Los Angeles Fisheries v. Crook, 47 F. 2d 1031 (9th Cir. 1931).

[61] Kemper v. Lohnes, *supra* note 56.

[62] LOSS, SECURITIES REGULATION 1001-1003, 876-882 (1951); Dean, *The Federal Securities Act:* I,

It is perhaps significant that in cases of criminal liability for violation of Section 17(a) of the Securities Act, as well as for violation of the mail frauds statute,[63] convictions have been upheld even where the designated media (mails, etc.) were not used to transmit the actual misrepresentation.[64] The slightly different language of Section 17(a) as against Section 12(2) of the Securities Act lends itself more readily to the interpretation that any use of the mails or interstate facilities which is in furtherance of a scheme to defraud in the sale of securities is within that Section.[65] In turn, the language of X-10B-5 (to use mails "in connection with" sale or purchase) is even more favorable to the broad interpretation.[66] Now then, if a defrauded buyer who could invoke Section 12(2) of the Securities Act in a civil suit against the seller can elect instead to proceed on the theory of the *implied* civil liability of Section 17(a) of that Act, or of Rule X-10B-5 (as embracing all that is within said Section 17(a) as well as more), the buyer might succeed under the implied liability theory where he would fail under the narrow interpretation of the express liability provisions. Again, this brings up the paradox problem, already discussed and the corresponding decisional uncertainty. As for the aggrieved *seller*, however, it has been held that he can avail himself of the concededly broad mail-and-interstate-facilities reach of X-10B-5;[67] The mail-use requirement under X-10B-5, even in a civil liability case, has been judicially recognized as being closer to the language of Section 17(a) of the Securities Act (as applied in criminal cases) than to that of Section 12(2) of the Securities Act.[68]

Even intrastate use of the mails or, perhaps, of other media of transportation or communication may be the basis of this federal "jurisdiction." As to the mails, there is little doubt: use of mails to transmit between points in the same state is

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8 FORTUNE 50, col. 2 (Aug. 1933); Douglas and Bates, *The Federal Securities Act of 1933*, 43 YALE L. J. 171, 183 n. 51 (1933). Notes: 59 YALE L. J. 1120 (1950); 49 COL. L. REV. (1944); 50 YALE L. J. 90, 100-101 (1940). See also the combined SEC and industry statement submitted in hearings on the 1941 amendment program: PROPOSED AMENDMENTS TO THE SECURITIES ACT OF 1933 AND TO THE SECURITIES ACT OF 1934, *Hearings before the House Committee on Interstate and Foreign Commerce*, Part 3, 77th Cong., 1st Sess. 806 (1941).

[63] 18 U. S. C. §1341 (Supp. 1952).

[64] United States v. Monjar, 147 F. 2d 916 (3d Cir. 1944) (violations of both mail frauds statute and Securities Act §17(a); the misrepresentations were made orally but the mails were used by defendants in communicating with each other); United States v. Kopald, Quinn & Co. (unreported) CCH FED. SEC. LAW SERV. ¶2801.16 (U. S. Dist. Ct., N. Dist. Ga., Atlanta Div., April 9, 1937) (mailing of confirmation of sale; violations of §17(a) of Securities Act), *aff'd*, Kopald-Quinn & Co. v. United States, 101 F. 2d 628 (5th Cir. 1939), *cert. denied*, Ricebaum v. United States, 307 U. S. 628 (1939). See also, in the *Monjar* case, *supra*, Judge McLaughlin's interpretation of Pace v. United States, 94 F. 2d 591 (5th Cir. 1938) as holding that an offense under Securities Act, §17, is shown by the mailing of letters expressing thanks for orders given to salesman. Under the mail frauds statute it need only be shown that the mailing was in furtherance of a scheme to defraud, which can raise some nice questions where the only use of the mails is, say, in the clearance of the victim's check on an out-of-town bank. See Kann v. United States, 323 U. S. 88 (1944) and United States v. Sheridan, 329 U. S. 379 (1946), in their implications for that problem.

[65] See §17(a) quoted *supra* p. 508; see also Northern Trust Co. v. Essaness Theatres Corp., 103 F. Supp. 954, 962-964 (N. D. Ill. 1952).

[66] See last line of X-10B-5, quoted *supra* p. 508; see also preceding footnote.

[67] Northern Trust Co. v. Essaness Theatres Corp., *supra* note 65.

[68] Northern Trust Co. v. Essaness Theatres Corp., *supra* note 65.

sufficient to satisfy the mail-use requirement of these statutes.[69] As to media other than the mails, it is entirely possible that the use of a "through" train or plane, which is en route to out-of-state points, in transmitting the forbidden matter even between points in the same state amounts to a "use of means or instruments of transportation . . . in interstate commerce," the train or plane in question being such a "means" or "instrument."[70] It would seem rather far-fetched, however, to make a similar conclusion with respect to a car moving only *intrastate* simply because it is traveling along a route that leads to out-of state points. Query whether transportation of the liar himself on his way to sell the victim, might not be the equivalent of transporting false written matter. Perhaps it may plausibly be argued that a sale by use of a long-distance phone call between two points in the same state is a sale by use of "means or instruments of . . . communication in interstate commerce" where the connection is automatic and the call may be automatically relayed through out-of-state points, unknown to either party. In the leading case for the narrow view of the reach of Section 12(2) of the Securities Act through federal channels, the oral misrepresentations in a deal between a Chicago seller and a Chicago buyer were made in Chicago, as also were payment and delivery—all apparently involving none of the features above mentioned.[71]

Under the broad view above indicated, however, it would seem that, at the least, any use of the mails or interstate facilities *in furtherance* of the scheme would be enough to bring into play the various civil liability sections of these federal statutes.[72] By that view a court should have little trouble in applying this legislation to a case where the aggrieved party made contact by mail with the other party in answer to an advertisement by the latter in a newspaper of interstate circulation and appointments for meetings were made by mail.[73] (Perhaps such an advertisement itself might be enough, even if followed by no mailings.) It does not follow, however, even under the broad view, that if federal channels are used in any phase of the transaction, the transaction is within the Acts; there might still be a question, for example, where the only mailing involved is the inter-bank movement of the buyer's check after it has been cashed by the seller at a bank other than the drawee bank.[74]

Moreover, even under the broad view of the federal channels jurisdiction, it is arguable, in a civil liability case under Section 12(2) of the Securities Act, that the *transportation* of a security through the mails (etc.) is to be distinguished from other

[69] Deckert v. Independence Shares Corp., 39 F. Supp. 592 (E. D. Pa. 1941); Gross v. Independence Shares Corp., 36 F. Supp. 541 (E. D. Pa. 1941). Both these cases were under §12(2). See to same effect, in a suit by the SEC to enjoin fraudulent practices in sale of securities, SEC v. Timetrust, Inc., 28 F. Supp. 34 (N. D. Calif. 1939), *appeal dismissed on stipulation*, 118 F. 2d 718 (9th Cir. 1941).

[70] The statutory language under discussion is not like that of the Mann Act, 36 STAT. 825 (1910), 18 U. S. C. §398 (1946) forbidding transportation "in interstate commerce" (as defined in that Act), which has been construed to exclude transportation between points in the same state. United States v. Wilson, 266 Fed. 712 (E. D. Tenn. 1920) (indictment insufficient, even though the route taken incidentally passed through another state). Under the Fair Labor Standards Act, 29 U. S. C. §201 *et seq.* (1946), employees driving cars between two points in the same state may be "engaged in interstate commerce." Airlines Transp. v. Tobin, 198 F. 2d 249 (4th Cir. 1952).

[71] Kemper v. Lohnes, *supra* note 56.

[72] See cases cited *supra* note 64.

[73] *Cf.* Kemper v. Lohnes, *supra* note 56.

[74] See cases cited *supra* at end of note 64.

aspects of the "sale" and that, accordingly, that Section does not apply if the only use of the mails (etc.) is in carrying the security for delivery or for the purpose of sale. The argument is highly technical: the word "sale" has the same meaning in Section 12(2) as in Section 12(1); in turn, Section 12(1) imposes civil liability on sellers for violation of Section 5; and Section 5 not only forbids use of the designated federal channels "to carry or cause to be carried" a security, along with "to sell or offer to buy," but it also forbids such carriage "for delivery after sale" as well as "for the purpose of sale"—all of which (according to this argument) goes to show that the forbidden "sale" imposing civil liability under Section 12(2) does not include *delivery*. There is judicial support for this argument,[75] as well as against it,[76] the latter bolstered by the fact that "sale" is defined in the Act to include delivery unless the context otherwise requires.[77]

X-10B-5 AND THE WRONGED SHAREHOLDER NOT A PURCHASER OR SELLER—"PRIVITY"

Unless the act of which the plaintiff complains is "in connection with the purchase or sale of any security," X-10B-5 does not apply. Obviously X-10B-5 does not give then, a federal statutory cause of action for that range of wrongs to shareholders which are categorized in our jurisprudence as breaches of fiduciary duties, where no purchase or sale of securities is involved. Furthermore, the only reported case on the point, the *Birnbaum* case,[78] holds that even if a sale of securities is involved, still there is no X-10B-5 cause of action by one who is neither the purchaser nor seller. Both the statutory provision upon which X-10B-5 rests and the Rule itself, said Judge A. N. Hand of the Second Circuit, are not directed at fraudulent mismanagement of corporate affairs but rather were meant as a protection to the defrauded seller or buyer. By this view, then, "selling the corporation down the river," as by a sale of its "control shares" to known corporation pirates, accompanied by resignations and substitutions in favor of the purchasers, does not violate X-10B-5, even if it otherwise falls within "any device, scheme or artifice to defraud" or within other phraseology of X-10B-5. An unreported case is said, however, to take the opposite view, presumably based on a more literal interpretation of the X-10B-5 outlawry of practices which "would operate as a fraud or deceit upon *any* person in connection with the purchase or sale of a security."[79]

Indeed, this aggrieved-buyer-or-seller view of X-10B-5 seems to have suffered a further judicial twist in the recent *Farnsworth Radio*[80] case in the direction of a

[75] Gross v. Independence Shares Corp., 36 F. Supp. 541 (E. D. Pa. 1941).

[76] Schillner v. H. Vaughan Clarke Co., 134 F. 2d 875 (2d Cir. 1943); Moore v. Gorman, 75 F. Supp. 453 (S. D. N. Y. 1948).

[77] Securities Act §2(3).

[78] Birnbaum v. Newport Steel Corp., 193 F. 2d 461 (2d Cir. 1952), noted 100 U. OF PA. L. REV. 1251 (1952).

[79] McManus v. Jessup & Moore Paper Co., Civ. No. 8015 (E. D. Pa. July 30, 1948), cited in LOSS, SECURITIES REGULATION 841 n. 104 (1951) and in Note, 4 STAN L. REV. 308, at 310 n. 5 (1952), and in Note, 100 U. OF PA. L. REV. 1251, 1253 n. 15 (1952).

[80] Joseph v. Farnsworth Radio & Television Corp., 198 F. 2d 883 (2d Cir. 1952), *aff'g* 99 F. Supp. 701 (S. D. N. Y. 1951), without opinion other than a brief per curiam statement that "the order is affirmed on the opinion below . . . and the subsequent decision in Birnbaum v. Newport Steel Corp. . . ." Frank, J. dissented.

"privity" requirement under X-10B-5. In that case a person who bought stock on the open market (from persons not parties to the misrepresentations) brought an X-10B-5 action against the directors who had published false information about the corporation, as a result of which the stock was quoted higher than it otherwise would have been and the plaintiff purchased the stock at a price which fell when the truth became known. In dismissing the complaint (with leave to plead anew), Sugarman, J., in the District Court, said that "a semblance of privity between the vendor and purchaser . . . seems to be requisite and is entirely lacking here." The case has been strongly criticized as not even embodying the more enlightened common law attitudes towards privity in the misrepresentation area, much less the more advanced statutory philosophy;[81] it has been further criticized as a *non sequitur*[82] from the *Birnbaum* rule (upon which the Court of Appeals purported to rely) that X-10B-5 protects only defrauded sellers or purchasers: here the aggrieved party *was* a purchaser. However, there is an intimation in the District Court's opinion that it would have held otherwise if the purchaser had *relied* on the false statement, an intimation that might afford an X-10B-5 basis for an action by one who buys into or sells out of a corporation (whether it be a close corporation or a "public" corporation) on the basis of false information calculated to influence that purchaser or seller. For instance, an accountant who prepares a false statement which he knows is to be used in putting over a deal in shares of a corporation, close or otherwise, might well fall within X-10B-5, even under the *Birnbaum* reasoning. (This is aside from the question, already discussed, of how far can X-10B-5 be available to *purchasers.*) Perhaps the "semblance of privity" mentioned in the *Farnsworth Radio* case is merely another name for the requirement that the relying plaintiff must be of the class whom the misrepresentation was intended to influence—an unfortunate name for an over-conservative position even at common law.[83] The privity requirement, in that sense, would seem readily satisfied if the nefarious scheme is specifically aimed at a particular person, as would probably be the normal situation in deals in shares of close corporations.

Neither the *Birnbaum* case nor the *Farnsworth Radio* case *necessarily* eliminates X-10B-5 as the basis of a shareholder's derivative suit where he complains that the corporation has sold shares to dominating insiders at a wrongfully low price or has bought shares from such insiders at a wrongfully high price, to the injury of the corporation. The gist of such a complaint would be injury to the corporation as purchaser or seller, and there would be no question about the "privity" of the corporation. The *Birnbaum* dictum that X-10B-5 is not a redress for fraudulent mismanagement of corporate affairs would seem irrelevant in such a situation.[84]

It is even possible that X-10B-5 offers hope to the diluted shareholder in the classic

[81] Note, 4 STAN. L. REV. 308 (1952); Frank, J., dissenting in the *Farnsworth Radio* case, *supra* note 80, at 884 *et seq.*

[82] Frank, J., *supra* note 81.

[83] See PROSSER, TORTS 732 (1941); Ultramares Corp. v. Touche, 255 N. Y. 70, 174 N. E. 441 (1931).

[84] *Cf.* Note, 100 U. OF PA. L. REV. 1251, 1254 (1952).

squeeze play in close corporations: the offering of a new issue at a ridiculously low price (made to look innocent, perhaps, by offering it at par) to existing shareholders with the knowledge that the minority-holder against whom the squeeze is directed (say, the widow of the deceased 30 per cent shareholder) will be unable to take the pro-rata portion, coupled with the expectation that any outside financing of a purchase by the minority holder is unlikely. (In a publicly held corporation, a low-price pre-emptive offering to shareholders does not present the same diluting dangers —or at least only to a negligible degree.) The doctrine developed by state courts has not always coped adequately with this problem.[85] Perhaps a fresh start can be made under X-10B-5. In the case where the squeeze play ends in the purchase by the management-majority of the minority's shares at a cheap price, it is not too difficult to find the aggrieved "seller." But even if the diluting pre-emptive offer is not taken up by the shareholder who is the target of the scheme, with the result that the shares in question are then sold to the insiders at that same low price, the situation would seem to be one which, in the language of X-10B-5, is a "device to defraud" or an "act which operates as a fraud or deceit"—all "in connection with the purchase or sale of a security." Indeed, it is even technically arguable that in such a situation there has been a "sale" to the aggrieved shareholder: "sale" is defined in the Securities Act to include any "offer to dispose of" a security and presumably has an equally broad meaning in the Exchange Act, particularly in view of the almost identical language of X-10B-5 under the Exchange Act and of Section 17(a) of the Securities Act.

Another question that arises under the view that the aggrieved party must be a buyer or seller in order to come within X-10B-5 is whether the change in a corporation's securities that occurs as a result of some fundamental change voted by the shareholders is to be viewed as a sale of the "old" security and a purchase of the "new" one; if so, a shareholder who can in other respects work up an X-10B-5 case can meet the seller-or-buyer requirement. True, the problem is less likely to occur in close corporations than in publicly held corporations, since in a close corporation the fully informed insiders frequently own that majority of the shares which enables them to effect a charter amendment or a reincorporation (as by sale of assets for the securities of the newly formed acquiring corporation) or such infrequent close corporation transactions as merger or consolidation. Still, it is entirely possible that even in a close corporation the vote of a shareholder outside the "management group" is needed. For example, the applicable law may require a vote by classes and the outsider may own the preferred; or that law may require the favorable vote of 75 per cent of the shares and a few outsiders may own 26 per cent. Is there a "sale" (or "purchase") when the rights of shares are changed by a fundamental corporate alteration pursuant to such voting? To "sell" is defined in the legislation

[85] See 13 FLETCHER CORPORATIONS §5840 (1943 replac. vol.); Schramme v. Cowin, 205 App. Div. 20, 199 N. Y. Supp. 98 (1st Dep't 1923); Scheirich v. Otis-Hidden Co., 205 Ky. 289, 264 S. W. 755 (1924). *Cf.* Steven v. Hale-Haas Co., 249 Wis. 205, 23 N. W. 2d 620, 630-631 (1946); Gaines v. Long Mfg. Co., 234 N. C. 340, 67 S. E. 2d 350 (1951).

to include "to dispose of"; and to "buy" is defined to include to "otherwise acquire."[86] Is not a holder of a class of shares who has voted or been voted into a fundamental change in his shares in effect "disposing" of his old set of rights (his old shares) and "acquiring" a new set of rights? And is it not reasonably arguable that when he (and his class) is asked to vote, he (and his class) is being asked to sell out the present position and buy into a new position and should have the same protection against untruths, half-truths and non-disclosures as any buyer or seller? The SEC, however, at an early day took the "no sale" view of such corporate changes; the present SEC Rule,[87] however, goes no further than to say that for the purpose of the registration and prospectus requirements of the Securities Act no sale is involved in such corporate changes.[88] In the only reported decision to date, the court took the no-sale view of the change in securities effected through a merger, agreeing, without discussion, with the (then) view of the SEC's amicus curiae brief.[89] Whether a court would now be influenced by the changed view of the SEC,[90] and hold contrary to this judicial decision is anybody's guess.[91]

Buyer's Section 12(2) Advantages and Disadvantages As Against State Law

Measured against his common law or equity prospects under the traditional doctrines relating to deceit and to rescission, the buyer, even after successfully clearing the jurisdictional hurdle of the federal channels, finds the following disadvantages under Section 12(2) of the Securities Act:

1. The Section is available only against the seller, not against others who by their deceit may have induced the purchase.

2. The seller is in the clear under Section 12(2) if he can show that he was not at fault in making the misrepresentation; classical rescission, on the other hand, can rest on "innocent" misrepresentation.

3. The misrepresented fact must be "material" under Section 12(2) even if the misstatement was intentional; classical rescission, on the other hand, dispenses with materiality, under the decisions of most states, if the fraud was intentional.[92]

4. The Section 12(2) cause of action is subject to the short "one-and-three" year period of limitations.[93]

5. If, having sold the security, the buyer seeks damages under Section 12(2), the damages recovered will, from the rescission-flavor of Section 12(2), presumably be measured by the out-of-pocket rule;[94] on the other hand, if the seller's act amounts

[86] Securities Act §2(3); Exchange Act §3a(13) and (14).

[87] Securities Act Rel. No. 3420 (1951), 17 Code Fed. Regs. §230.133 (1951 Supp.).

[88] See discussion in Loss, Securities Regulation 334 *et seq.* (1951).

[89] National Supply Co. v. Leland Stanford Jr. University, 134 F. 2d 689 (9th Cir. 1943).

[90] See SEC statement in Securities Act Rel. No. 3420 (1951), CCH Fed. Sec. Law Serv. ¶2128.01.

[91] See discussion by Loss, *supra* note 88, at 339 n. 119, of instances in other SEC legislation where fundamental changes are treated as "sales" or "purchases."

[92] Restatement, Restitution §§9, 28; Restatement, Contracts, §471, comment *i*; Restatement, Torts, §538, comment *g*.

[93] Securities Act, §13.

[94] Shulman, *Civil Liability and the Securities Act*, 43 Yale L. J. 227, 244 (1933).

to common law "fraud," the damages in some states in an action for deceit are measured by the loss-of-bargain rule.[95]

On the other hand the buyer (if he has cleared the jurisdictional hurdles) may find in Section 12(2) the following advantages:

1. He may get relief (damages) under Section 12(2) even though he has disposed of the security. Under state law he might find money recovery impossible because the facts may not constitute a cause of action in "deceit," and rescission doctrines would be of no help because he cannot restore the status quo.

2. The *scienter* requirement and its plaintiff's burdens of proof are absent in Section 12(2). Indeed, no burden of proof of seller's fault of any kind is on the plaintiff buyer; it is up to the seller to establish the defense that he did not know and in the exercise of reasonable care could not have known of the untruth or omission.

3. The buyer need not *prove* that he relied on the falsity or omission, nor does he have to prove that by the exercise of reasonable care he could not have ascertained the falsity or omission,[96] whatever be the local state rule on that point; he need only prove that he did not know of the untruth or omission. This should not be confused with the requirement that the buyer has to prove that the stated or omitted fact is "material."[97]

4. The buyer may expect a more liberal view of what constitutes a misrepresented "fact" than in some, at least, of the state courts.[98]

5. Under Section 12(2) the buyer can resort to the federal courts. Indeed, the buyer has an attractive choice: he can sue under Section 12(2) in the federal courts, he can sue under Section 12(2) in the state courts, and he can sue in the state courts (or in federal courts under the "diversity" jurisdiction) on the state-law cause of action.[99] In a Section 12(2) action the plaintiff buyer also has a wide choice of venue in the federal courts and the advantage of nation-wide service of process.[100]

Since this discussion is concerned with deals relating to shares of close corporations, we need not explore the relative merits for the buyer of Section 12(2) over state blue sky remedies. By virtue of exemptive provisions, the typical blue sky law does not ordinarily reach "private" deals, although it may be otherwise in an occasional state.

[95] McCORMICK, DAMAGES §121 (1935).

[96] Murphy v. Cady, 30 F. Supp. 466 (D. Me. 1939), *aff'd*, 113 F. 2d 988 (1st Cir. 1940).

[97] As to "material" facts see RESTATEMENT, TORTS §538(2).

[98] Compare the possible intimation of Judge Clarke in Rosenberg v. Hano, 121 F. 2d 818 (2d Cir. 1941), that the broker's representation that the stock would rise 15 points might constitute a cause of action under §12(2), with the view of a majority of the judges of one state court that a laundry machinery manufacturer's representations that his new machinery would do the laundry-man-buyer's work "more economically and with less labor" than his present machinery (made by this same manufacturer), are only "opinion," not misrepresentations of "facts." American Laundry Machinery Co. v. Skinner, 225 N. C. 285, 34 S. E. 2d 190 (1945).

[99] Securities Act, §22(a) provides that the federal district courts and the state courts shall have concurrent jurisdiction of suits in equity and actions at law to enforce any liability created by the Securities Act. State courts cannot reject jurisdiction so conferred by Congress. Testa v. Katt, 330 U. S. 386 (1947).

[100] Securities Act §22(a).

PLAINTIFF'S X-10B-5 ATTRACTIONS, AS AGAINST STATE LAW

The chief disadvantages of X-10B-5 lie in the somewhat unsettled questions, already discussed as to:

(1) Whether X-10B-5 applies *at all* to deals in shares of close corporations, *i.e.*, "private" deals. (However, this can perhaps now be regarded as settled.)

(2) Whether the cause of action under X-10B-5 extends at all to *buyers*.

(3) Whether, if it is capable of such extension, it is fettered or unfettered by the restrictions accompanying Section 12(2) of the Securities Act.

(4) The extent to which the use of federal channels is necessary to bring X-10B-5 into play. (But collateral use seems sufficient.[101])

(5) Whether X-10B-5 is available to one who has neither bought nor sold but who complains, say, of a pre-emptive offering schemed to dilute him.

(6) Whether "privity" or "some semblance of privity" is required for an X-10B-5 action—meaning, by "privity," not privity of contract but that the person relying on the misrepresentation must have been within the ambit of persons whom the defendant actually intended to harm by the misrepresentation. In deals in shares in close corporations this "privity" issue is not likely to be crucial, for the misstatement of which the plaintiff will be complaining will ordinarily be that of a defendant who was the other party to the contract or of some defendant (most probably an insider) who not only could reasonably have anticipated that persons like the plaintiff would rely on the misrepresentation but who, indeed, intended that this plaintiff would rely thereon.

The attraction of X-10B-5 for a plaintiff lies in its broad sweep with respect to (implied) civil liability. The forbidden acts are broadly characterized in the Rule's three lettered paragraphs; to paraphrase, liability arises from (a) using any scheme to defraud, (b) making an untrue or half-true statement of a material fact, or (c) doing anything that operates as a fraud or deceit on anybody, so long as the proscribed act is "in connection with the sale or purchase of any security"; and the liability extends to "any person"—all subject to such limitations upon these generalities as courts may develop.[102] On the whole, in view of the general protection of "investors" sought by the federal legislation, the courts have shown little of the restrictive common law attitude that one associates with, say, the action for deceit. "Fraud" (and "to defraud") and "deceit," as used in X-10B-5, are not to be limited by the common law standards of fraud and deceit.[103] Indeed, complete silence may constitute the forbidden "scheme to defraud" of paragraph (a) as well as the "fraud

[101] Fratt v. Robinson, 203 F. 2d 627 (9th Cir. 1953).

[102] The argument that X-10B-5 is unconstitutional, as being in contravention of the Fifth Amendment (due process), by reason of vagueness, indefiniteness, and uncertainty if the words "fraud" and "deceit" as used therein seek to impose higher standards than are imposed under their common law connotations, was dismissed, with citation of authorities, as "shop worn" and rejected by other courts" in Speed v. Transamerica Corp., 99 F. Supp. 808, 831 (D. Del. 1951) (Leahy, J.).

[103] See Speed v. Transamerica Corp., *supra* note 102; Kardon v. National Gypsum Co., 83 F. Supp. 613 (E. D. Pa. 1947).

or deceit" of paragraph (c) of the Rule,[104] even if it escapes the half-truth proscription of paragraph (b).

Pending further specific decisions on X-10B-5, the attitude of the federal courts with respect to factors relevant to liability based on misrepresentation can perhaps be forecast from other provisions in these SEC Acts. Under Section 17(a) of the Securities Act, for instance, opinions, promises or representations as to the future can support a charge of "fraud."[105] A false statement in a Registration Statement of present intention is a misstatement of "fact," violative of the Securities Act.[106] If the misrepresented fact must be "material" (as under paragraph (b) of X-10B-5 and the similarly worded paragraph (2) of Section 17(a) of the Securities Act), it is no defense that an ordinary person would not have been fooled; it is enough, that the "credulous" have been or (in an injunctive proceeding) would be fooled.[107] As for intent to defraud and scienter, even in criminal prosecutions for engaging in a "scheme to defraud" (which is the language of the Mail Frauds Act and of Section 17(a) as well as of X-10B-5), mere belief in the truth of false statements is no defense if the falsity could have been known by the exercise of reasonable diligence.[108] It may be, however, that under at least the "*scheme* to defraud" language of paragraph (a), and perhaps even under the "fraud or deceit" language of paragraph (c) of the Rule, a belief in the truth of a statement is a good defense if based upon reasonable grounds for so believing after a reasonable inquiry into its truth, as against a belief, say, based on grounds that "would be an insult to the intelligence of any businessman of experience."[109] But under paragraph (b) of X-10B-5 conceivably even an honest mistake after use of due care to learn the truth would seem to give rise to liability, although if the action is by a *buyer* against his seller the court might read into the Rule the well-founded-honest-belief limitation of Section 12(2) of the Securities Act; if the court does not do so, there is presented that paradox previously discussed, a paradox that, as we have seen, is not altogether avoided even if the court puts no such limitation on a buyer's action against persons not parties to the sale or on a seller's action. Perhaps in an X-10B-5 action based upon misrepresentation, a *buyer* plaintiff would be well advised to allege and prove the defendant's (at least, a defendant seller's) "guilty knowledge," even though it be a watered-down scienter, on the theory that such a plaintiff would carry enough of a burden to justify freeing him from restrictions like those in Section 12(2) of the Securities Act, thus minimizing the "paradox" argument.[110]

There is nothing in X-10B-5 to indicate that "reliance" by the aggrieved party

[104] Speed v. Transamerica Corp., *supra* note 102.

[105] United States v. Grayson, 166 F. 2d 863, 866 (2d Cir. 1948) (criminal proceedings).

[106] Oklahoma-Texas Trust v. S. E. C., 100 F. 2d 888 (10th Cir. 1939) (review of SEC stop order proceedings).

[107] S.E.C. v. Timetrust, Inc., 28 F. Supp. 34 (N. D. Calif. 1939) (injunction proceedings under said Section 17(a) by SEC.).

[108] Stone v. United States, 113 F. 2d 70 (6th Cir. 1940).

[109] S. E. C. v. Macon, 28 F. Supp. 127 (D. Col. 1939) (injunction proceedings by SEC under §17(a) of the Securities Act).

[110] See Fischman v. Raytheon Mfg. Co., *supra* notes 45-47 and corresponding text discussion.

on the untruth or omission is dispensed with. Even traditional equitable rescission, which the philosophy of X-10B-5 perhaps incorporates,[111] requires reliance.[112] Reliance, in turn, ties in with the "privity" concept, for that label is often given to the requirement that a misrepresentation must have been intended, or at least reasonably expected, to induce reliance by the plaintiff or by the class which includes the plaintiff. The conservative common law position is that in business deals the defendant is liable to the relying plaintiff only if he *intended* that the plaintiff (or a class which includes the plaintiff) should have relied on the misstatement and even then only if in relying thereon plaintiff entered upon the type of transaction in which the defendant intended to influence the plaintiff or his class.[113] By that view if an insider should deliberately put out false high earning statements so that he can sell his shares at a good price, he is probably not liable to those who, relying on his statements, buy from another stockholder. (He only *intended* to defraud those who bought *his* shares?) The *Farnsworth Radio* case, previously discussed,[114] seems to embody this conservative common law attitude under its "semblance of privity" requirement in an X-10B-5 action. True, the opinion leaves an avenue of escape from its restrictiveness: there was no allegation that the plaintiff, suing the defendant insiders, *relied* on the false statement. Although one may quarrel with this suggestion of required individualistic reliance when the statement is published to the world to influence the market and "the market" does, presumably, rely on the publication, one may feel entitled to view that case as consistent with the proposition that the "privity" requirement is satisfied if the defendant can reasonably have expected that the plaintiff or the class which includes the plaintiff would have been induced by the misrepresentation to buy or sell in reliance thereon, as the plaintiff *did*. In a close corporation the issue of personal reliance versus reliance as part of the market does not arise. Indeed, in a close corporation, the occasion to distinguish between "intent" to influence the plaintiff in the deal and "reasonable expectation" that the plaintiff would be influenced is unlikely to arise with frequency. Moreover, in venturing prediction in this field, one must not overlook the criticism evoked by the *Farnsworth Radio* case[115] and its inconsistency with the general spirit of this federal legislation as well as with such liability for misleading statements as is imposed by Section 18(a) of the Exchange Act.

Insiders, Non-disclosure, and X-10B-5. It is particularly in the field of non-disclosure by insiders buying from shareholders that X-10B-5 came into prominence.[116] At common law, in a purchase by a director or officer of shares from a shareholder, traditional legal lore tells us that there are three rules: (1) the stranger-analogy rule (no greater duty on such a buyer than on a stranger to reveal to his seller facts

[111] New York's anti-fraud act relating to securities, which contains language in parts remarkably like that of X-10B-5, has been analogized to equitable rescission for innocent misrepresentations. People v. Federated Radio Corp., 244 N. Y. 33, 154 N. E. 655 (1926). N. Y. Gen. Bus. Law §352 (the "Martin Act").

[112] Restatement, Contracts §476, comment *c;* Shulman, *supra* note 94, at 233.

[113] Restatement, Torts, §531.

[114] *Supra* p. 520.

[115] *Supra* note 81.

[116] See cases cited *supra*, notes 4-8, 36.

known by the buyer but unknown to the seller which make the wares more valuable); (2) the fiduciary rule (directors and officers stand in a fiduciary relation to the shareholder whose shares they are buying, hence under duty to disclose such facts); and (3) the "special circumstances" rule (duty of insider to disclose in "special circumstances," an example of which is the pendency of negotiations for the sale of the corporate properties at a high price). Even if one were to urge the thesis that the actual decisions of the courts are not so divergent as their doctrinal pronouncements[117] it still remains true that here is a field where differences in judicial attitudes, as well as in attitudes outside those circles, can be expected, even if everyone agreed on the same verbal formula. It may well be, therefore, that a plaintiff who detects, or believes that he detects, on the part of the local state court a tendency toward the stranger-analogy attitude would do well to consider resorting to X-10B-5. For example, in one case the very same facts that gave rise to an X-10B-5 action were held by the same court to create no cause of action under local state law, in that case Kentucky law, where an insider was buying from a shareholder without disclosing material inside information.[118] With respect to X-10B-5 Judge Leahy observed, in a subsequent proceeding in that case, that[119]

> The rule is clear. It is unlawful for an insider, such as a majority stockholder, to purchase the stock of minority stockholders without disclosing material facts affecting the value of the stock, known to the majority stockholder by virtue of his insider position but not known to the selling minority stockholders, which information would have affected the judgment of sellers.

Despite the apparent leaning of the foregoing statement toward the fiduciary rule, as is characteristic of X-10B-5 decisions,[120] the cases that have actually arisen under X-10B-5 have involved either actual misrepresentation (or at least half-truths) by the defendant or at least those "special circumstances" of non-disclosure which, it is

[117] This writer ventures that adherence to a "special circumstances" rule, coupled with a close analysis of those circumstances, is a more fruitful approach than contentions about the prevalence of this or that rule about existence of a "fiduciary duty." However, no analysis can reconcile with the main body of modern doctrine, nor justify, such extreme cases as Connolly v. Shannon, 105 N. J. Eq. 155, 147 Atl. 234 (1929).

[118] Speed v. Transamerica Corp., 71 F. Supp. 457 (D. Del. 1947) (granting defendant's motion for summary judgment on the common law count but denying it with respect to counts based on X-10B-5). Subsequently, in a decision on the merits, the court reconsidered and reversed its position with respect to the common law count, on the ground that in the light of the evidence, the statements made by the insider-purchaser were so misleading as to constitute common law fraud and deceit. Speed v. Transamerica. Corp., 99 F. Supp. 808 (D. Del. 1951). Compare on the common law aspect, the decision by the same court in an identical transaction against the same defendant: Geller v. Transamerica Corp., 53 F. Supp. 625 (D. Del. 1943), especially on petition to review, 63 F. Supp. 248, 251 (D. Del. 1945) (dictum: no breach of common law duty under Kentucky law, even if insider-purchaser had already formed a plan to dissolve the corporation and thereby capture, on liquidation, the high value of its properties).

[119] Speed v. Transamerica Corp., 99 F. Supp. 808, 828-829 (D. Del. 1951). Although Judge Leahy added that one of the purposes of the Exchange Act is to protect *public* security holders against misuse of inside information by insiders, X-10B-5 has been applied, as already noted, to purchases by insiders in a close corporation. See other cases cited *supra* notes 4, 5, 6, and 8.

[120] A duty-to-disclose attitude under X-10B-5 is found also in other cases. *E.g.*, Kardon v. National Gypsum Co., 73 Supp. 798, 800 (E. D. Pa. 1947).

believed, would have induced most courts (except perhaps those of New Jersey) to grant the plaintiff relief even under state law. The non-disclosure in those cases related to such matters as the insider-purchaser's preexisting secret negotiations to sell the corporate properties for a high price,[121] or current secret negotiations for an important acquisition by the corporation,[122] or his plan, already formed, to use his power to liquidate and thus to capture for himself the corporation's liquidating value, which exceeded the going-concern value.[123] Indeed, in the *Transamerica* litigation, Judge Leahy dropped remarks which might lead one to believe that some such "special circumstance" is essential for an X-10B-5 non-disclosure action and that mere non-disclosed knowledge by insiders of facts making the shares more valuable is not enough for an X-10B-5 action;[124] however, it must not be overlooked that he found that the non-disclosure in question would have been harmless had it not been tied up with the already formed plan to liquidate.[125] So, even under Judge Leahy's remarks in the *Transamerica* case, which seem to be the most favorable to be found for the defendant in an X-10B-5 non-disclosure case, the test seems to be, after all, whether the non-disclosed fact would have influenced the seller's judgment. This is definitely more favorable to the plaintiff than the so-called majority rule in state courts.[126] One may anticipate, under this test, that mere non-disclosure of identity of the insider who uses a straw man to buy up shares in a close corporation is enough, without further special circumstances," for an X-10B-5 recovery, at least unless the purchaser can prove that the price was fair.[127]

That X-10B-5 embodies the fiduciary rule need not lead to the *in terrorem* argument that no insider can buy "without first letting the shareholders in on his knowledge, foresight, reading of the times or other motives for buying."[128] The litigated cases reveal a cashing in on knowledge far different from a mere "reading of the times."

It may be observed that the above indicated attitude of the federal courts toward X-10B-5 can readily be made to fit into the Rule's literal language if, as appears from the previous discussion, the term "fraud" is not given its strict common law meaning. The court should have no great difficulty in finding that the proscribed non-disclosure violates at least paragraph (c) of Rule X-10B-5 as an act or practice which operates as

[121] Kardon v. National Gypsum Co., 73 F. Supp. 780 (E. D. Pa. 1947).
[122] Northern Trust Co. v. Essaness Theatres Corp., 103 F. Supp. 954 (N. D. Ill. 1952).
[123] Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951).
[124] *Id.* at 814, 821.
[125] In writing to other shareholders offering to buy their shares at a stated price, the majority shareholder did not disclose that the corporation's tobacco inventory, which was shown in the last report to shareholders "at cost" of $7,516,970, had a market value of $17,000,000. Judge Leahy apparently found as a fact that if there had been no intent to liquidate, disclosure of the increased inventory would still have permitted the buyer to secure the stock at the stated prices. *Id.* at 826. Other triers of facts might well come to a different finding in this situation, it is believed.
[126] See 3 FLETCHER, CORPORATIONS §1168.1 (1947 replac. vol.).
[127] *Cf.* Taylor v. Wright, 69 Cal. App. 2d 371, 159 P. 2d 980 (1945) (common law recovery).
[128] See, as to misgivings about the fiduciary rule, Walker, *The Duty of Disclosure by a Director Purchasing Stocks from His Stockholders*, 32 YALE L. J. 637, 639 (1923).

a fraud,[129] or paragraph (a) as a scheme to defraud; courts have even shown a disposition to bring in paragraph (b), the half-truth proscription, in these non-disclosure cases.[130]

The disclosure duty under X-10B-5 has been imposed not merely on directors and officers but on the insider dominant shareholder as well.[131] Whether a state court purporting to follow the duty-to-disclose rule against purchasing directors or officers would do likewise with respect to dominant shareholders is not clear, for lack of judicial decisions. A plaintiff pursuing such a defendant might be more inclined, therefore, to use X-10B-5.

For that matter, X-10B-5 has potentialities for further extending the range of non-disclosing defendants. Be it noted again: under X-10B-5 it is unlawful for *any person* to do the forbidden acts, not merely any officer, director or dominant shareholder. For instance, it would seem that if the corporation itself is buying from a shareholder the duty of disclosure should be as extensive as if an insider were buying.[132] One X-10B-5 complaint that withstood a motion to dismiss was against the purchasing corporation, although it is not clear that the selling shareholder was complaining merely of nondisclosure.[133] Even a redemption of preferred shares (or other senior securities) might be a violation of X-10B-5 if coupled with non-disclosure of facts which, if known, might induce the holders to exercise a conversion privilege.[134] Also, despite doubts that have been expressed to the contrary,[135] a minor employee should perhaps not be excluded from an X-10B-5 duty to disclose; one might venture that a secretarial employee violates Rule X-10B-5 if she uses knowledge of special circumstances, acquired in the course of her work, to purchase shares from a shareholder. Rule X-10B-5, as interpreted, shows no predilection for that view which sees a duty running only to "the corporation" and not to the selling shareholder. It has been suggested that even an "outsider" who picks up private information in the course of business negotiations with a corporation might violate X-10B-5 in secretly using that information to buy up the corporation's share,[136] although one

[129] Kardon v. National Gypsum Co., 83 F. Supp. 613 (E. D. Pa. 1947).

[130] See Kardon v. National Gypsum Co., 73 F. Supp. 798, 800 (E. D. Pa. 1947); Speed v. Transamerica Corp., 99 F. Supp. 808, 828 (D. Del. 1951).

[131] Speed v. Transamerica Corp., *supra*.

[132] See Comment, 59 YALE L. J. 1120, 1149-1154 (1950); *cf.* Note, 59 HARV. L. REV. 769, 776 (1946); Gladstone v. Murray Co., 314 Mass. 584, 50 N. E. 2d 958 (1943) (here the officer buying for the corporation was said to owe a duty to do his best for the corporation and not to owe a duty to the selling shareholder; however, the court reached the same result even with respect to shares purchased by that officer-stockholder for himself).

[133] Northern Trust Co. v. Essaness Theatres Corp., 103 F. Supp. 954 (N. D. Ill. 1952). Perhaps Zahn v. Transamerica, 99 F. Supp. 808, at 843 ff. (D. Del. 1951) looks in the same direction. LOSS, SECURITIES REGULATION 831 (1951) expresses the view that X-10B-5 overrides any conflicting obligation of management to buy at bargain prices.

[134] See Zahn v. Transamerica Corp., 99 F. Supp. 808 at 843 ff. (D. Del. 1951); see also, Zahn v. Transamerica Corp., 162 F. 2d 36 (3d Cir. 1947).

[135] Note, 59 HARV. L. REV. 769, 774 (1946).

[136] Note, 39 CALIF. L. REV. 429, 434 (1951); Comment, 59 YALE L. J. 1120, 1144 (1950). The situation hypothesized in the latter is where Corporation A plans to buy out Corporation B's assets or securities at a high price and a director of A goes out and buys shares in Corporation B at an underprice. See also LOSS, SECURITIES REGULATION 829 n. 67 (1951).

wonders how far courts would go with that idea.

In a transaction in shares of a close corporation, it would not be surprising if courts were to hold that X-10B-5 is violated by one who, without disclosure of that fact, buys from a shareholder on the basis of specific inside information which he knows comes from an insider who would himself (the insider) fall with X-10B-5.[137] The recipient of a "trade secret" in analogous situations takes subject to a constructive trust on his gains; perhaps X-10B-5 can do likewise for this other recipient of breach-of-trust information.[138] Also, it might be only realistic to raise at least a presumption having weight as evidence that close corporation purchases by a member of an insider's immediate family are made on the basis of the insider's knowledge. To conceive of such purchasers as participants in an "act that would operate as a fraud" on the selling shareholder would seem not out of keeping with the philosophy of X-10B-5, even if a more tolerant view be taken, at least at common law, of market purchases by insiders' relatives or because of insiders' tips, in view of their greater impracticability of disclosure.[139]

When it comes to *sales* by an insider, as well as by the corporation itself whether on original issue or reissuance, the non-disclosure aspect in a deal in shares of a close corporation is likely to merge into actual misrepresentations or at least half-truths, for it is difficult to visualize such a sale without some sales talk, some representations. In this respect, an insider's sell-out in a close corporation presents a different picture from an insider's sale "in the market" on the basis of inside bearish information.[140] Accordingly then, the buyer into a close corporation will have been aggrieved by at least half-truths and will find several provisions seemingly available to him under this legislation, *viz.*, X-10B-5 paragraph (b), Section 17(a) of the Securities Act, Section 12(2) of the Securities Act and, though rarely in close corporation deals, Rule X-15C1-2(b) relating to half-truths by a broker or dealer. Whether these half-truth provisions offer a plaintiff any advantage (again, in light of the buyer's X-10B-5 troubles, previously discussed) over state law will depend on how "advanced" local law is with respect to recognition of half-truths as misrepresentations.

Further X-10B-5 Attractions? A glance at the broad X-10B-5 proscriptions of schemes to defraud, half-truths and acts and practices that would operate as a fraud, coupled with a glance at the decisions already cited under X-10B-5, suggests that the plaintiff under X-10B-5 gets the benefit of at least the most "liberal" common law views, if indeed not more. Would a preferred shareholder who has been redeemed after liquidation had been decided upon and who will get less on redemption than on liquidation have an X-10B-5 action even if full disclosure is made? It would seem

[137] See Note, 39 CALIF. L. REV. 429, 434 (1951).

[138] *Id.* at 437 ff., relying on RESTATEMENT, RESTITUTION §201(2).

[139] *Cf.* at common law, on purchases in the market by insider's mother, wife, and friend where, however, the seller was not complaining, *In re* Calton Crescent, Inc., 173 F. 2d 944, 949, 950-951 (2d Cir. 1949), and dissent by Learned Hand. *Aff'd sub nom.* Manufacturers Trust Co. v. Becker, 338 U. S. 304 (1949) (no consideration of the point). See also Note, 39 CALIF. L. REV. 429, 435 (1951).

[140] *Cf.* Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701 (S. D. N. Y. 1951), *aff'd*, 198 F. 2d 883 (2d Cir. 1952).

so,[141] although perhaps even a "liberal" common law recognizes his grievance.[142] Will the buyer negotiating for the purchase of corporate property with an insider whom he knows or suspects to be buying up his associates' shares at an under-price be liable to the seller under X-10B-5? Perhaps so.[143] One soliciting a sale (or purchase, presumably), even though not himself a purchaser (or seller) and though making no false statements, may be liable as a knowing participant in the scheme to defraud, under X-10B-5.[144]

Moreover, the X-10B-5 liability, as well as liability under Section 12(2) of the Securities Act, extends to every person who controls any person liable under those provisions, by the express provisions of Section 20 of the Exchange Act and Section 15 of the Securities Act, respectively, subject to somewhat differing "innocence" qualifications under the two sections.

Jurisdictional and Venue Advantages of X-10B-5. As in the case of liability under Securities Act Section 12(2), the plaintiff may have a fairly wide choice of forum under X-10B-5, except that the choice is restricted to the federal courts. The plaintiff may bring his suit in the district where the violative act or transaction occurred or in the district where the defendant is found or is an inhabitant or transacts business, and process may be served in any other district where the defendant is an inhabitant or wherever he may be found.[145] Since there are technical differences between the venue provisions relating to liability to a purchaser under Section 12 of the Securities Act and those relating to the X-10B-5 liability under the Exchange Act, this divergence can raise again the question whether a defrauded *buyer* can choose an X-10B-5 liability or is restricted to the Section 12(2) liability and its narrower venue.[146] The fact that the act of which the plaintiff complains is also an actionable wrong by local common law or statutory law does not bar suit in the federal court under X-10B-5, or under any other provision of these federal statutes or SEC Rules thereunder.[147] The various restrictive doctrines surrounding diversity jurisdiction are, of course, irrelevant to suits based upon these federally created causes of action.

Remedy under X-10B-5. The aggrieved seller suing the purchasing insider has been held entitled to recover for his share of the profits made by the purchaser

[141] Zahn v. Transamerica Corp., 99 F. Supp. 808, 843 ff. (D. Del. 1951).

[142] Zahn v. Transamerica Corp., 162 F. 2d 36 (3d Cir. 1947).

[143] The point became eliminated from the decision in Kardon v. National Gypsum Co., 73 F. Supp. 798 (E. D. Pa. 1947).

[144] Fry v. Shumaker, 83 F. Supp. 476 (E. D. Pa. 1947). "In fact, it would be sufficient if they had merely mailed a letter without knowing its contents or even had merely supplied their stationery, providing they knew that in so doing they were rendering service essential to or participating in a scheme of fraud." *Id.* at 478 (Kirkpatrick, J.).

[145] Exchange Act, §27. For examples of extraterritorial service under X-10B-5, see Kardon v. National Gypsum Co., 73 F. Supp. 798 (E. D. Pa. 1947); Rosenberg v. Globe Aircraft Corp., 80 F. Supp. 123 (E. D. Pa. 1948); Stella v. Kaiser, 82 F. Supp. 301 (S. D. N. Y. 1948).

[146] Rosenberg v. Globe Aircraft Corp., *supra*, took the restrictive view. The problem is part of the "paradox" problem previously discussed, *supra* p. 000.

[147] Stella v. Kaiser, *supra* note 145.

who, having thus acquired all the stock, sold the corporate assets at a high price;[148] recovery has also been allowed for damages, measured by the difference between what defendant paid and what the stock was worth.[149] Rescission would also seem available.[150] The possibility of the remedy of a shareholder's derivative suit, on behalf of the defrauded corporation whether buyer or seller, is not to be overlooked.[151]

The Period of Limitations under X-10B-5. An action under X-10B-5 by the *buyer* against the seller in a close corporation deal presents of course that unsettled question, already discussed, whether he is subject to at least the restrictions of a Securities Act Section 12(2) case, including the one-and-three year limitations applicable to that Section, if his grievance falls within that Section, as it generally will. A plaintiff who has not bestirred himself into rather prompt litigation may, accordingly, prefer to take his chances with state law rather than risk an X-10B-5 case only to find that it is after all only a Section 12(2) case which is barred either absolutely by the lapse of three years or by the lapse of one year because he could have discovered the untruth within that time if he had exercised reasonable diligence.[152] Usually the state period is longer, frequently (depending on the state) being extended by the period of the plaintiff's ignorance of the fraud.

The foregoing troublesome aspect aside, an X-10B-5 plaintiff will on the whole be no worse off, limitations-wise, than in resorting to a state-law cause of action. Since there is no specific period of limitations relating to X-10B-5 and since there is no general federal statute of limitations, not even for federally created causes of action, the federal court in an X-10B-5 litigation will apply the local state statute of limitations,[153] at least if the plaintiff is not pursuing an equitable remedy like rescission or accounting for profits so as to bring into play the federal doctrine of laches relating to federally created equitable causes.[154] Although it is arguable that, no matter which remedy an X-10B-5 plaintiff is pursuing, the local state limitations statute, including one which starts running before discovery of the fraud, is applicable anyhow, since the X-10B-5 remedy is not exclusively equitable,[155] it is also arguable that in fraud cases the federal doctrine that the period of limitations on a federally created cause of action does not start to run until the plaintiff discovered or ought to have discovered the fraud still applies, for, as stated in a Supreme Court

[148] Kardon v. National Gypsum Co., 73 F. Supp. 798 (E. D. Pa. 1947).

[149] Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951); Northern Trust Co. v. Essaness Theatres Corp., 103 F. Supp. 954 (N. D. Ill. 1952). See also Fry v. Shumaker, 83 F. Supp. 476 (E. D. Pa. 1947) (damages against non-buyer participants).

[150] See Fry v. Schumaker, *supra*.

[151] See Slavin v. Germantown Fire Ins. Co., 174 F. 2d 799 (3d Cir. 1949) (corporation as seller); Stella v. Kaiser, 82 F. Supp. 301 (S. D. N. Y. 1948) (corporation as buyer).

[152] Securities Act, §13.

[153] Fischman v. Raytheon Mfg. Co., 188 F. 2d 783 (2d Cir. 1951); Northern Trust Co. v. Essaness Theatres Corp., 103 F. Supp. 954 (1952); Osborne v. Mallory, 86 F. Supp. 869 (S. D. N. Y. 1949). Incidentally, two of these X-10B-5 cases involved a *buyer* plaintiff.

[154] See Cope v. Anderson, 331 U. S. 461 (1947) and cases there cited, especially Russell v. Todd, 309 U. S. 280 (1940).

[155] See cases in preceding footnote. The point was perhaps involved, but was not discussed in Northern Trust Co. v. Essaness Theatres Corp., *supra* note 153 (state statute held applicable).

case, "it would be too incongruous to confine a federal right within the bare terms of a State statute of limitations unrelieved by the settled federal equitable doctrine as to fraud, when even a federal statute in the same terms would be given the mitigating construction required by that doctrine."[156] Frequently the local state statute of limitations has a shorter period for a liability created by statute than for a fraud action; it is not clear whether in an X-10B-5 action the federal court will purport to apply the local state court characterization or will itself characterize an X-10B-5 action as in essence a "fraud" action. In the only X-10B-5 case passing on the point, it seems that the federal court made its own characterization of the action as fraud, although it indicated that the state view was the same.[157]

CONCLUSION

One conclusion is fairly obvious: whether a plaintiff who deems himself aggrieved by a sale of shares in a close corporation would be better off suing under state law or under this federal legislation depends so much on the law of the state in question that no categorical generality can be ventured. Perhaps the suggestion is warranted that a wronged *seller* is at least as well off, and probably much better off, suing under X-10B-5. The wronged *buyer* may be well advised to take his chances with state law unless by that law his prospects are definitely on the dark side. The aggrieved holder who is neither himself the buyer nor seller nor suing on behalf of the buyer or seller (as in a shareholder's derivative suit) also perhaps had better stick to state law, despite certain suggestions in the foregoing discussion, unless his chances there are dim indeed or unless he is fired with the ambition to put his name to a leading case.

[156] Mr. Justice Frankfurter in Holmberg v. Armbrecht, 327 U. S. 392, 397 (1946) (not an X-10B-5 case); see also to same effect, Winkler-Koch Engineering Co. v. Universal Oil Prod. Co., 100 F. Supp. 15, 29 (S. D. N. Y. 1951) (triple damages under the Clayton Act).

[157] Fratt v. Robinson, 203 F. 2d 627 (9th Cir. 1953).

THE ENGLISH PRIVATE COMPANY

L. C. B. Gower*

Since 1908 the expression "Private Company" has been a term of art with a precise statutory definition. This definition, however, was merely the culmination of a long historical development and it is perhaps advisable to commence this short account of an immensely important branch of English Company Law by a brief summary of its historical background.[1]

Until 1844 there were no arrangements in England for speedy and cheap incorporation. The boon of corporate entity could only be obtained by a special Act of Parliament or by obtaining a charter from the Crown and neither was readily procurable. Hence business men and their advisers had tried to mould the unincorporated partnership into a form which would provide most of the advantages of corporate personality without a formal grant of incorporation. Thanks to the ubiquitous trust concept their efforts met with considerable success and produced a form of joint stock company organized under a Deed of Settlement which vested the property of the concern in Trustees, divided it into transferable shares, and entrusted its management to directors who would normally be the same as the trustees.

The unincorporated Deed of Settlement Company was subject to three main disadvantages, all flowing from the fact that in the eyes of the law it was merely a partnership although often swollen to a size which destroyed any possibility of the mutual confidence between the members which was supposed to be at the root of partnership law: (1) The members were personally liable for the obligations of the firm without limitation of liability; (2) the gravest procedural difficulties arose when the company was suing or being sued or when execution was being levied on its property or that of its members; and (3) it was doubtful whether even express provision in the Deed of Settlement could effectively provide for complete freedom of transferability of shares. While the Bubble Act[2] remained in force, the better view was that some limitation on transfers was essential,[3] and even after the Act was repealed in 1825[4] doubts still remained.[5] Hence share transfers were normally

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[1] The best accounts of the most important periods are A. B. Dubois, The English Business Company After the Bubble Act, 1720-1800 (1938); B. C. Hunt, The Development of the Business Corporation in England, 1800-1867 (1936). For a recent short account of the whole development, see C. A. Cooke, Corporation, Trust and Company (1950).

[2] 6 Geo. I, c. 18 (1720).

[3] This was the view taken by professional opinion immediately after the passing of the prolix and obscure Act (see Dubois, *op. cit. supra* note 1, at 3 *et seq.*) and is supported by the nineteenth century decisions of which there is a good account in Hunt, *op. cit. supra* note 1, at cc. II and III.

[4] By 6 Geo. IV, c. 91.

[5] They were only finally eradicated in 1843: Garrard v. Hardey, 5 Man. & G. 471, 134 Eng. Rep. 648 (C. P. 1843); and Harrison v. Heathorn, 6 Man. & G. 81, 134 Eng. Rep. 817 (C. P. 1843).

subject to express restriction and this, coupled with the fact that shares entailing unlimited liability were not readily marketable, tended at first to restrict the use of unincorporated Deed of Settlement Companies to groups of business men with common interests. Having regard to this, it is interesting to note that, already in the eighteenth century, the term "private company" was in use to distinguish such concerns from public companies incorporated by charter or statute.[6]

During the early nineteenth century, however, there was an enormous growth of company promotions, genuine and fraudulent,[7] and methods of evading the members' legal liability were developed. The chaotic state of the law forced the legislature to intervene, at first hesitantly,[8] but under the influence of Gladstone, then President of the Board of Trade, more boldly in the first great Companies Act of 1844.[9] This Act enabled companies to become incorporated by registering their Deeds of Settlement with the Board of Trade[10] and, for the first time, attempted to draw a clear-cut distinction between companies and partnerships by providing that associations of more than 25 persons (reduced to the present 20 in 1856) should be unlawful unless registered under the Act or formed under charter or statute. This Act, however, denied one of the most sought after consequences of incorporation—freedom from personal liability; its object was to regulate, not to encourage, speculation. Eleven years later, however, after lengthy and heated controversy in Parliament, Royal Commissions, Departmental Committees, the Press, and, indeed in every forum of public and commercial opinion, Parliament under pressure from the Government of the day passed the Limited Liability Act, 1855,[11] conferring limited liability on companies which completed registration under the 1844 Act. The method of limitation was the same as that adopted by statutory companies which already enjoyed that advantage; namely, the members were liable only to the extent of the unpaid liability on their shares which had to be given a fixed nominal value.[12]

The 1855 Act remained in existence only a few months when it and the 1844 Act, together with various intervening, amending and winding-up Acts, were repealed and consolidated in the Joint Stock Companies Act, 1856.[13] This swept

[6] Cf. the Statute of 1767 (7 GEO. III, c. 48) in which "public company" is used in the latter sense.

[7] A popular account of the *modus operandi* is Dickens' description of the "Anglo-Bengalee Disinterested Loan and Life Assurance Company" in MARTIN CHUZZLEWIT (1848).

[8] The Trading Companies Act, 1834 (4 & 5 WM. IV, c. 94) and the Chartered Companies Act, 1837 (1 VICT., c. 73) enabled the Crown by letters patent to confer any of the privileges of incorporation without a formal charter of incorporation. Little use was made of this power since the law officers and the Board of Trade were still imbued with the feeling of reluctance officially to recognize joint stock companies which had prevailed ever since the South Sea bubble in 1720.

[9] 7 & 8 VICT., c. 110.

[10] The Government Department which is responsible for company legislation, registration, and supervision. It fulfills some of the functions exercised in America by the Securities and Exchange Commission but with far less extensive powers. In England, in this, as in a surprisingly large number of other spheres, there is far less state control than in the United States of America.

[11] 18 & 19 VICT., c. 133.

[12] English law still does not recognize no-par-value shares. A bill to legalize them failed to obtain a second reading (the first stage of debate) when introduced by a private member in 1952. In the same year a Departmental Committee was set up to consider the matter; it has not yet reported.

[13] 19 & 20 VICT., c. 47. This Act for the first time extended registration to Scotland and included

away most of the safeguards which the 1855 Act had provided,[14] retaining only the fundamental principle on which the 1844 Act had been based—the principle of publicity. If the liability of the members was to be limited the word "Limited" had to appear as the last word of the company's name, acting as a red flag warning the public of the dangers they ran if they dealt with the organization.[14a] This and the possibility of ascertaining details of the company's structure from inspection of the public register were thought to afford the public all the protection they deserved. Laissez faire had triumphed.[15]

After this date there were two main legal forms for commercial enterprise in England: the registered company, incorporated and with limited liability, and the unincorporated partnership or sole trader whose business was not personified by incorporation and whose liability was necessarily unlimited. If over 20 persons were interested in the business an unincorporated partnership was illegal; if the number of members was over 6[16] but not more than 20, incorporation was an optional alternative to partnership, but, if the number was less than 7 a partnership was the only possibility and limited liability was unobtainable.

Hence, or so it was thought, the one demand which had not been met was for a method of limiting the liability of the members of a small family concern. Registration was thought of primarily as a method of enabling the entrepreneur to obtain capital from the public. Not, of course, that there was any compulsion on the company or its promoter to make any general public invitation: the value of registration to smaller and more closely knit concerns was clearly recognized and the name "private company" became associated with them.[17] But the 1856 Act had prescribed a minimum of 7 members for a registered company, thus apparently ruling out the one-man business or the small family partnership.

The consequence was agitation for the introduction of limited partnerships on the lines of the Continental *société en commendite,* a form of partnership with both general and limited partners derived from the *commenda* of Roman law. This had never taken root in England. Indeed, anything approaching it was ruled out by the

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provisions for winding up which previously has been dealt with separately. Banks and insurance companies were excluded until 1858 (20 & 21 VICT., c. 49 and 21 & 22 VICT., c. 91) and 1862 (25 & 26 VICT., c. 78) respectively.

[14] The 1855 Act had required a minimum issued and paid up capital, personal liability of the directors if they paid a dividend knowing the company to be insolvent, Board of Trade approval of auditors, and obligatory winding up if three-fourths of the capital was lost.

[14a] The arbitrary exclusion of freedom from liability despite incorporation which had prevailed in the preceding 12 years made this necessary and accounts for the fact that English companies are still distinguished by "Ltd." instead of the more logical "Inc." used in the United States.

[15] Parliament had, in effect, accepted the view of Lord Bramwell in the *Report of the Mercantile Law Commission*, 27 BRITISH PARLIAMENTARY PAPERS 445 (1854), that "if ever there was a rule established by reason, authority and experience, it is that the interest of a community is best consulted by leaving to its members, as far as possible, the unrestricted and unfettered exercise of their own talents and industry," and that this golden rule demanded the recognition of limited liability provided only that those seeking to take advantage of it openly announced this in the name under which they traded.

[16] The Act prescribed a minimum of 7 members.

[17] For an early use of this term by the judiciary, see *In re* British Seamless Paper Box Co., 17 Ch. D. 467, 478 (1881), per Cotton, L. J. Palmer first published his *Private Companies* in 1877.

prevailing idea that any sharing of net profits was conclusive evidence of partnership,[18] an idea which was not finally proved unsound until 1860.[19] In the meantime many efforts had been made to do something about it,[20] but nothing materialized until 1865 when the Mercantile Law (Amendment) Act[21] (commonly known as Bovill's Act) provided that lenders, or sellers of goodwill, receiving a share of profits should not be conclusively presumed to be partners but that they should be deferred creditors in the event of bankruptcy. At the time it was thought that this had effected a substantial advance, but in truth it only protected the creditor where he was not associated in the running of the business,[22] and where, indeed, he had recently secured protection at common law.

When this was realized there was a renewed outbreak of attempts to legalize full-fledged limited partnerships on the Continental model and it was from one such abortive attempt that the Partnership Act, 1890,[23] resulted, although this, in its final form, merely codified the existing law. In reality, however, the agitation was misconceived, for the existing companies' legislation enabled all the advantages of limited partnerships, and more besides, to be obtained at very little price. This first became plain in the epoch-making case of *Salomon v. Salomon*[24] which reached the House of Lords in 1897. In 1892 Salomon, being then fully solvent, had promoted a company to acquire his business which he sold to the company for a large sum satisfied mainly in shares and debentures. He held all the shares except six, each of which was registered in the name of a member of his family apparently as a nominee for him. Within a year the company fell a victim of a trade recession and its assets were merely sufficient to discharge the debentures,[25] nothing being left for the unsecured creditors. In these circumstances Vaughan Williams, J., and a strong Court of Appeal held that the company was a mere sham—an alias, agent, trustee, or nominee—for Salomon who remained the real proprietor of the business and who was accordingly liable to indemnify the company against its debts. But the House of Lords unanimously overruled this decision. They held that the company had been validly formed, since the Companies Acts merely required seven members holding at least one share each and said nothing about their being independent, or that they should take a substantial interest in the undertaking, or that they should have a mind and will of their own, or that there should be anything

[18] Grace v. Smith, 2 Wm. Bl. 998, 96 Eng. Rep. 587 (K.B. 1775).

[19] By the leading case of Cox v. Hickman, 8 H. L. Cas. 268, 11 Eng. Rep. 413 (H. L. 1860).

[20] Limited partnerships had been advocated by John Austin as early as 1825 (see PARLIAMENTARY HISTORY AND REVIEW 711 (1825)) and the Board of Trade obtained a report thereon from Bellenden Ker in 1837. 44 BRITISH PARLIAMENTARY PAPERS 399 (1837).

[21] 28 & 29 VICT., c. 86. This was an amended version of the bill originally introduced at the same time as the Limited Liability Act, 1855.

[22] Syers v. Syers, 1 App. Cas. 174 (1876); Pooley v. Driver, 5 Ch. D. 458 (1876).

[23] See the account by its draftsman, Sir Frederick Pollock, in the preface to the twelfth edition of his *Law of Partnership* (this preface is reprinted in the current fifteenth edition).

[24] [1896] A. C. 22.

[25] In fairness to the much maligned Mr. Salomon it should be said that he was no longer the holder (he having sold the debentures and used the money to try to support the tottering company) but the result would have been the same if he had been.

like a true balance of power in the constitution of the company. Hence the business belonged to the company and not to Salomon, and Salomon was its agent not *vice versa.* As the transfer to the company had not been in fraud of creditors it could not be set aside and Salomon was fully protected from liability for the company's debts.

This decision opened up new vistas to company lawyers and the world of commerce. It established the legality of the "one man" company and showed that incorporation was as readily available to the small private partnership and sole trader as to the large public company. It also revealed that it was possible for a trader not merely to limit his liability to the money which he put into the enterprise but even to avoid any serious risk to the major part of that by taking debentures and thus becoming a secured creditor. *Laissez faire* had triumphed to an extent which might have shocked its arch-apostle, Lord Bramwell.[26] Indeed, the decision did more, for it established the "corporate entity" principle in a particularly rigorous form and largely stultified all efforts by the courts to "lift the veil"—so much so that *lifting the veil,* that popular subject of academic discussion in the United States, is almost totally ignored in the English literature, and where the veil has been rent it is generally the result of express statutory enactment, for normally it is only the legislature which "can forge a sledge-hammer capable of cracking open the corporate shell."[27] This however is another story; to one aspect of it, germane to our present subject, we shall have to revert later.

By the beginning of the present century, therefore, the wheel had turned full circle. In the eighteenth and early nineteenth centuries joint stock enterprises had pressed into service the legal forms of partnership; now the compliment had been returned and the joint stock forms had come to annex the proper functions of the law of partnership.[28] Far from discouraging this development the legislature proceeded to relieve the incorporated partnership from some of the normal requirements of the Companies Acts. The Act of 1900,[29] in introducing various new formalities, exempted from a number of them "a company which does not issue any invitation to the public."[30] But it was by the 1907 Act,[31] embodied in the new Companies (Consolidation) Act, 1908,[32] that private companies were first given a statutory definition and clearly distinguished from others.[33]

[26] See note 15, *supra.* But as late as 1888 Bramwell was boasting of his part in introducing the legislation which made it possible; see his speech, *The Law of Limited Liability,* 9 J. INSTITUTE OF BANKERS 373 *et seq.* (1888).

[27] Per Devlin, J., in Bank Voor Handel en Scheepvaart v. Slatford, [1951] 2 All E. R. 779, 799.

[28] Cf. O. Kahn-Freund in his notes to RENNER, THE INSTITUTIONS OF PRIVATE LAW 331-332 (1945). Indeed, a similar development had taken place in the law of trusts, for the corporate trustee had come to its aid thus repaying the debt which earlier company law owed to trusts.

[29] 63 & 64 VICT., c. 48.

[30] See §§2 and 6 (and note the use of the expression "private company" in the marginal note to the latter).

[31] 7 EDW. 7, c. 50.

[32] 8 EDW. 7, c. 69.

[33] These others are commonly designated "public companies" but for this there is no statutory justification, apart from a casual reference in §181(5)(c); indeed that expression is rarely applied to a company limited by guarantee.

Section 121 of the 1908 Act (now Section 28 of the Companies Act, 1948[34]) defined a private company as one which by its articles:

(a) restricts the right to transfer its shares;[35] and

(b) limits the number of its members to 50;[36] and

(c) prohibits any invitation to the public to subscribe for any shares or debentures of the company.

The intention of the definition was to embrace small family concerns, but to exclude others; and on private companies as thus defined, this and later Acts have successively conferred a growing number of privileges and immunities.[37] The most important of these are:

(a) A private company need have only two members instead of a minimum of seven,[38] and one director instead of a minimum of two.[39]

(b) It can be formed more simply and therefore more cheaply, for it does not have to file a prospectus or statement in lieu of prospectus,[40] and its directors need not file in the public register written consents to act, or take up qualification shares prior to appointment.[41]

(c) It can commence business immediately on registration and does not have to obtain a "Trading Certificate" granted to a public company only after the Registrar is satisfied that the various statutory requirements regarding the flotation of its capital have been complied with.[42] Nor does it have to make a detailed report (the "Statutory Report") to the members on the flotation and to convene a General Meeting (the "Statutory Meeting") shortly after the date when the Trading Certificate entitles it to commence business.[43]

(d) It does not have to file in the public register copies of its accounts and thus make public its financial position.[44]

(e) Loans may be made by the company to its directors—a practice forbidden in the case of other companies.[45]

As the result of these provisions the expense of forming a private company may be astonishingly small,[46] and the amount of publicity comparatively slight. Hence

[34] 11 & 12 GEO. 6, c. 38.

[35] There is no statutory provision as to the nature of the restriction. In practice it is usual to give the directors an unfettered discretion to refuse transfer and this is sometimes coupled with a right of pre-emption by the existing shareholders.

[36] Joint holders are treated as one for this purpose (§28(2)), and the employees and former employees who became members while they were employed may be added to the 50 (§28(1)(b)). Unless otherwise stated, references hereafter to sections are to those of the Companies Act, 1948.

[37] It is unfortunate that the Companies Act nowhere sets out in one place which of its rules do not apply to private companies; this has to be culled laboriously from the Act as a whole. There are certain other differences in addition to the immunities mentioned in the text; for example a proxy can speak, as well as vote, at a meeting of a private company (§136).

[38] Sec. 1.

[39] Sec. 176. The directors can also be appointed more informally (§183(1)). And provisions relating to retirement on attaining the age of 70 do not normally apply (§185), but as a public company can contract out of these provisions, this is unimportant.

[40] Sec. 48.

[41] Sec. 181.

[42] Sec. 109.

[43] Sec. 130.

[44] Sec. 129. But see *infra*.

[45] Sec. 190. But see *infra*.

[46] It is possible to form a company with a capital of £1000 for as little as £25 (say $65.). Annual

Limited Partnerships, which were eventually introduced in 1907,[47] did not take root in English business life; the need for them had passed. By using the incorporated private company the liability of all the members can be limited and the members can play a part in the management without forfeiting this limitation. Limited partnerships, therefore, have been little used, and hardly at all, except in the case of certain professions where incorporation is forbidden by law or convention.[48]

All these advantages are valuable and the last two are particularly prized. No trader likes to have to make public the state of his financial affairs, and, even as regards public companies, it is only as a result of the latest Act that anything approaching full and frank disclosure has been ensured. But since 1908 the publication of a balance sheet has, on principle, been required[49] and the Act contains elaborate provisions designed to ensure that the balance sheet and profit and loss account give "a true and fair view" of the company's position.[50] A private company must, of course, prepare such accounts, but if it need not reveal them to the outside world its members will feel much happier. Similarly, the members of the "one-man" or other small company like to take advantage of the veil of incorporation when it shields them from liability, but in other respects to continue to regard the business as "theirs." In particular, they will probably be highly indignant if they cannot borrow money from the business when it suits them to do so. In so far as a private company is really just an incorporated partnership, it is perhaps not unreasonable that it should be privileged in this respect.

Private companies have therefore proved immensely popular and, at the end of 1952, some 260,800 were on the register with a total paid-up capital of some £2,330 millions. In contrast there were only about 11,600 public companies, although their total capital was greater, namely £3,970 million approximately.[51] Not all of these so-called private companies, however, are in fact fulfilling the economic role for which the machinery was designed. The statutory definition was based on a recognition that the legal form of joint stock company could perform two distinct roles;[52] first that of enabling masses of capital to be put to profitable use by others, and secondly that of enabling a small private concern to be personified so as to distinguish its legal rights and liabilities from those of its proprietors. The privileges of private companies were intended to be conferred only on incorporations for the latter purpose, but in fact public companies performing the former role have made use of

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expenses will in practice be little heavier than without incorporation. Winding up is apt to be more expensive but a formal liquidation may often be avoided by persuading the registrar to strike the company off the register under §353.

[47] 7 EDW. 7, c. 24.

[48] The registrations of limited partnerships in England total about 2000, and of these a considerable proportion are probably obsolete for the Act contains no provisions for the removal of registrations.

[49] See, now, §127.

[50] Sec. 149, 8th Schedule.

[51] BOARD OF TRADE; COMPANIES ANNUAL REPORT FOR 1952. These are the figures for the whole of Great Britain, including Scotland.

[52] Registered companies in fact perform yet a third role, that of providing a substitute for the charitable or "purpose" trust. For this the "company limited by guarantee" is especially suitable but it is hardly a joint stock company in the true sense.

private companies for their own purposes. A holding company in which the public is interested to the fullest extent may operate through subsidiary companies which can, and normally will, form as private companies since their shares will be wholly owned by the parent company and no public offer will be made of their securities. Nevertheless it is obvious that the public are vitally interested in them—albeit at second-hand—and that there can be no justification for granting them all the immunities intended to be enjoyed only by genuine private concerns.

Hence the latest Act makes a further attempt at a satisfactory definition by subdividing private companies into two classes—"exempt" and others. For this purpose it proceeds on rather different lines from those followed in 1908. Whether a company is a private one or not, depends not on whether it has fewer than 50 members and does not *in fact* make an invitation to the public but upon whether its articles limit the number of members and prohibit invitations.[53] But whether it has the status of an *exempt* private company depends on what in fact has happened to its members, directors, and securities. And the draftsman tried to lay down conditions which could be fulfilled, but could only be fulfilled, by a genuinely private concern. This he found difficult, and the resulting definition takes up a lengthy section[54] and a whole schedule[55] of the latest Act, and is highly complicated—perhaps unnecessarily so. But the basic principles are clear enough; the company's shares or debentures must not be held by a body corporate unless that is itself an exempt private company, its securities must not be held by nominees other than personal representatives or trustees of a family trust, the number of debenture-holders must not be more than 50,[56] and another company must not be a director of it. These conditions must be fulfilled as from the date of the commencement of the Act, or from the original formation of the company if formed later, but the Board of Trade may allow a company to qualify for the future notwithstanding past breaches of the conditions. If a company qualifies as exempt it continues to enjoy all the advantages of a private company as outlined above.[57] If it does not, it still enjoys most of these privileges, since these are regarded as immunities from requirements, essential only in the case of companies which themselves may make a public issue, but it loses the rights to withhold its balance sheet and profit and loss account from the public gaze and to make loans to its directors, *i.e.*, it is robbed of the rights which are most sought after.

As a result, it can hardly be doubted that the legislature has succeeded in restricting the full privileges of a private company to private concerns in the strict sense. Whether the resulting tripartite classification is necessary or desirable is more doubtful, and, if it is, it may be that the line has been drawn too strictly and

[53] So much so, that originally it did not forfeit its privileges even though the conditions were not in fact fulfilled, Park v. Royalties Syndicate, Ltd., [1912] 1 K. B. 330. Now by §29 it loses most of the privileges although it does not actually cease to be a private company.

[54] Sec. 129.

[55] Seventh Schedule.

[56] Its shareholders must, of course, already be restricted to 50 if it is to be a private company at all.

[57] And, indeed, is accorded two others; resolutions requiring filing at the Registry need not be printed (§143) and its auditor need not possess all the qualifications required in other cases (§161).

in a manner which causes unnecessary confusion. Certainly many genuinely private concerns may now find themselves on the wrong side of the line, while others may be quite uncertain on which side of it they fall. By failing to ban nominee shareholdings,[58] but nevertheless making the non-existence of such holdings a condition of exemption, the legislature has placed the management of some companies in an embarrassing position, for unless all the shares are held by the directors the latter may be quite unable to tell whether the company is exempt or not. Their annual returns will be accepted without the accounts if they certify that to the best of their knowledge and belief the conditions are, and always have been satisfied.[59] But if their belief is wrong, the company was not in law exempt and both it and the directors may incur liability accordingly.[60] About 73.5 per cent of the private companies on the register have claimed exemption.[61]

There is, however, one abuse that the latest Act has not prevented; indeed it is only in the last few years that it has become common practice. As already stated, on the formation of a private company many of the formalities necessary in the case of a public company are dispensed with. And under Section 30 a private company can be converted into a public one by making the necessary alterations to its articles and by merely filing a prospectus or statement in lieu of prospectus. It is not necessary for the directors to file consents to act[62] or for a Statutory Report to be made and a Statutory Meeting held,[63] or for a "Trading Certificate" to be obtained, before the company can commence business.[64] Hence it has become the almost invariable practice initially to form a private company even if it is intended immediately to convert it into a public one and to make a public issue. This reduces the law to an absurdity. If the requirements in question still fulfill any useful purpose (which is doubtful) it clearly should not be possible to evade them in this way; if in fact they are useless anyway, then they should be abolished outright.

Finally, it may be useful to attempt to indicate the principal reasons for the immense growth of private companies. The obvious reasons are the advantages which necessarily flow from corporate personality; separation of the property, rights, and liabilities of the company from those of its members, limited liability, facilitation of legal proceedings, and perpetual succession. It would, however, be misleading to suggest that these are today the main inducements leading to the formation of companies. To a far greater extent the advantages sought are greater facilities for borrowing and possible reduction of liability to income tax and death duties.

On the face of it, a company with limited liability will be in a weaker position than a partnership or individual trader in attempting to borrow. In fact, however,

[58] See REPORT OF THE COMPANY LAW AMENDMENT COMMITTEE (THE COHEN REPORT), CMD. No. 6659 (1945), which recommended compulsory disclosure by shareholders of whether they were beneficial owners or not, but this was rejected as unworkable.

[59] Sec. 129(1)(b).

[60] But a prosecution cannot be instituted under §127 except with the consent of the Board of Trade (§129(3)).

[61] BOARD OF TRADE: COMPANIES ANNUAL REPORT FOR 1952.

[62] Under §181. [63] Under §130. [64] Under §109.

this is not so/because of the severe restrictions placed by the Bills of Sale Acts, 1878-1882,[65] and the Bankruptcy Act, 1914,[66] on chattel mortgages by unincorporated concerns. Under the former Acts, a valid security on chattels cannot be granted, unless possession passes, except by a publicly registered Bill of Sale in the statutory form. Registration of a Bill of Sale is regarded as calamitous from the point of view of a trader's credit, and, in any case, the statutory form requires that the goods be detailed in a schedule, thus effectively preventing a floating charge over the stock-in-trade in whatever form it happens to be from time to time. Furthermore, on bankruptcy there vest in the trustee in bankruptcy, for the benefit of the creditors generally, all goods "in the possession order or disposition of the bankrupt, in his trade or business, by the consent and permission of the true owner, under such circumstances that he is the reputed owner thereof."[67] Hence a floating charge over the stock-in-trade is impracticable. But the provisions in the Bills of Sale Acts relating to mortgages do not apply to registered companies,[68] and neither does the "reputed ownership" clause in the company's liquidation.[69]

Hence it is not uncommon for a business, which carries a valuable stock-in-trade but has no assets which can be specifically mortgaged, to be converted into a private company solely for the purpose of being able to borrow on debentures conferring a floating charge. If the personal undertaking of the members is also required they can, of course, be made to guarantee repayment. Although the debentures must be publicly registered,[70] this has in practice no very serious effect on the company's credit—presumably because the practice has become so common.

The question of taxation is too large a problem to be more than mentioned here. All that can be said is that real or imagined taxation advantages have in the last thirty years been the most common motive of all for incorporation, and that these thirty years have seen a battle between taxpayers, seeking to take advantage of the veil of incorporation to evade taxes which would otherwise be payable, and the Revenue, which has stopped up the gaps in its defenses by tearing the veil aside until it is now in shreds. As regards taxes on income, the principal advantage of incorporation is that it may save surtax—the additional impost charged on individuals but not generally on companies. Today, however, savings in this respect, in the case of companies controlled by fewer than 5 people, are dependent on a "direction" not being made apportioning the undistributed income among the proprietors resulting in the tax being recoverable either from them or from the company itself.[71] In the case of such companies, too, it is now highly unlikely that there will be any saving of duties on the deaths of the proprietors, and here again

[65] 41 & 42 VICT., c. 31 and 45 & 46 VICT., c. 43.
[66] 4 & 5 GEO. V, c. 59.
[67] Baukruptcy Act, 1914, §38, 4 & 5 GEO. 5, c. 59.
[68] Bills of Sale Act, 1882, §17.
[69] Gorringe v. Irwell India Rubber and Gutta Percha Works, 34 Ch. D. 128 (1886).
[70] Under Part III of the Companies Act, 1948.
[71] Income Tax Act, 1952 (15 & 16 GEO. & 1 ELIZ. 2, c. 10) §§245-264, re-enacting provisions dating from 1922.

the company itself may be made liable to pay.[72] Furthermore, certain additional duties—Profits Tax and Excess Profits Levy—may now be imposed on companies although they are not payable by individuals or partnerships. In the light of these factors, incorporation as a private company may often prove detrimental rather than beneficial.

There can be little doubt that it is the burden of taxation which is the most serious problem facing private companies today. During the last century an increasingly large part of the economy of this country has been in the hands of private companies, and from private companies many of the most important public companies have sprung. The view is now widely held that over-taxation is having a stultifying effect upon their development and growth, and the National Union of Manufacturers have recently urged the Chancellor of the Exchequer to set up an impartial committee of inquiry.[73]

If this problem can be solved there is little doubt that private companies will continue to play an increasingly important role in that (the larger) sector of the economy which is left to private enterprise. The legal rules afford a remarkably suitable and readily available framework; indeed, the main criticism of them is that they may be too easily available and too cheap. Until a hundred years ago incorporation and limited liability were only obtainable at too high a price; now we seem to have gone to the other extreme. There is one private company on the register with an authorized capital of ½d divided into two ¼d shares. Yet this company is enabled to trade with all the advantages of corporate personality! It may well be that there is a case for insisting on a minimum capital to be paid up in cash.[74] This might not be a great protection to the public (for the capital may be lost), but it would at least mean that promoters would have to pay a reasonable price for the license to use that potentially dangerous weapon, the limited liability company. Today it almost seems to have been forgotten that the word "Limited" was intended as a red danger flag—indeed it is often regarded as an indication of size and stability. That this should be so is a tribute to the morality of the English commercial community and indicates the very small extent to which they have abused the privileges of incorporation. Nevertheless, the possibilities of abuse are plain and abuses do occur. In this respect freedom may have amounted to license —and a remarkably cheap license at that.

[72] Finance Act, 1940 (3 & 4 GEO. 6, c. 29), §§46 *et seq.* as amended by later Acts.

[73] They supported their plea by a report from the Economist intelligence unit: see the London Times, Dec. 22, 1952. The Chancellor agreed to review death duty anomalies.

[74] Or a deposit with the Board of Trade. The COHEN REPORT, *op. cit. supra* note 58, rejected such suggestions on the ground that they would discriminate unfairly against persons of small means. This seems unrealistic. It is precisely people of small means who need protection against loss in the event of failure of companies with which they have had dealings. One might as well argue that it discriminates against the poor to refuse to allow firms to carry on the business of insurance without putting up a deposit or to own an automobile without paying premiums on a third party insurance.

THE CLOSE CORPORATION IN FRENCH AND CONTINENTAL LAW

Jacques Treillard*

In order to enable the Anglo-Saxon reader to understand this study in continental law, it is necessary to give a brief outline of the European law relating to corporations.

There are two prevailing systems in Europe: the German and the French. In this study we shall more especially deal with the solutions adopted by those legal systems and when going into detail, shall refer to the other European systems merely incidentally.

The two leading systems of continental law, *viz.*, the German and the French, admit the same kind of associations.

There is first a group of associations in which emphasis is laid on the personality of the partners (*intuitus personae*); they are known as personal associations.

There is further a group of associations in which stress is laid on the importance of money (*intuitus pecuniae*); they are known as capital associations.

Accordingly, business associations are arranged in the German and French legal systems as follows:

I. Personal associations (*sociétés de personnes; Personalgesellschaften*)
   - A. Partnerships (*sociétés en nom collectif; offene Handelsgesellschaften*);
   - B. Limited partnerships (*sociétés en commandite simple; Kommanditgesellschaften*).

II. Capital associations (*sociétés de capitaux; Kapitalgesellschaften*)
   - A. Companies in which some members are liable with, and at least one member without, limitation[1] (*sociétés en commandite par actions; Kommanditgesellschaften auf Aktien*);
   - B. Public limited companies (*sociétés par actions or sociétés anonymes*; *Aktiengesellschaften*).

German law approximates to the group of public limited companies another type of corporation, viz., the private limited company (*Gesellschaft mit beschränkter Haftung*), but French law prefers to consider the private limited company (*société à responsabité limitée*) as a type *sui generis.*

The liability of the members differs with every type of association and, in

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[1] This type of companies is unknown in English and American law.

Germany as in France, liability is the main criterion distinguishing these types of association. In personal associations the member is, on principle, personally liable for all debts of the corporation; conversely, in capital associations the member is, on principle, only liable for the amount of money which he has put, or undertaken to put, into the joint stock.

Every type of association has assets which consist of the contributions of the members. For his contribution, the member is given a share which represents his right in the association. In the personal associations, these shares are called *parts sociales; Kapitalanteile*. In the capital associations, they are called *actions; Aktien*. In the French private limited company they are likewise called *parts sociales* and in the German private limited company they are known as *Geschäftsanteile*.

Generally speaking, the possibility of transferring the member's share in the association is related to the question of liability.

As regards personal associations, a transfer of shares is, on principle, prohibited because the members of these associations wish to keep their ranks closed and to exclude the admission of strangers without their consent. They are compelled by statute to maintain the privity of their association. Conversely, in capital associations, the personality of the members is immaterial. The shares of the big companies are frequently anonymous in order to facilitate their free circulation among the public. They are made out to bearer and can often be bought at the stock exchange; anyone may purchase them for purposes of investment, speculation, gamble, in short, for financial reasons, and they are rarely purchased for the purposes of joining a particular enterprise unless it is intended to acquire a controlling interest in it. A public limited company such as the *Crédit Foncier de France* has about 60,000 members most of whom do not know one another; the management of such a large company must, of course, be independent of the constantly changing body of shareholders.

In the French and German private limited company the shares can be sold to strangers but, as will be seen later, their transfer and circulation is not as easy as that of the shares in a public limited company.

The fact that the transferability of the shares is the more easy the less the *intuitus personae* asserts itself, is of prime importance in discovering the true nature of the close corporation.

What is a close corporation? It is difficult to give a concise answer to that question because there is no precise definition of that type of association. Such a definition does not exist, either in the Anglo-American legal system or on the continent of Europe. However, it is not impossible to describe what is meant by a close corporation; it is a type of corporation which theoretically admits the free transfer of its shares but, for special reasons, "closes its door" and prevents strangers from acquiring its shares. Why do these corporations close their door? Because the members want to maintain the privity of their association and to protect themselves against the intrusion of undesirable outsiders.

Close corporateness is, thus, a self-defense reaction of the members of a company.

This description of the characteristics of close corporateness simplifies the task of the comparative lawyer. Indeed, every association which, by any means, prohibits the free transfer of its shares, falls under the concept of the close corporation. This applies, of course, to associations the very nature of which prohibits such free transfer, *viz.*, personal associations, as defined earlier;[2] no problem calling for legal analysis arises in connection with them; the members are statutorily prohibited from selling their shares and, in view of this prohibition, *cadit questio*.[3] These associations, "close" by nature and definition, are of no interest in this present research; to examine them in detail here, would be like carrying coals to Newcastle.

In France and Germany, the concept of close corporateness can be materialized by the legal form of the public as well as the private limited company. Normally these companies admit the free transfer of their shares; exceptionally, however, they may prevent their members from transferring them. In these exceptional cases, these companies acquire the character of close corporations in the true sense of the word. It is intended to examine in the following paragraphs the measures which have to be adopted in continental law in order to give those types of companies the character of close corporations.

The close corporation concept can be carried into effect in two ways: either the members may protect themselves against the intrusion of strangers by inserting into the articles of association of the company restrictive clauses permissible under the act under which the company is incorporated or by which it is governed; these clauses will render it difficult or impossible to sell or transfer the shares. Or else, the act itself protects the members by imposing on them a statutory obligation to control the transfer of shares in their company.

It should be pointed out that in both cases the restrictions are ultimately derived from the act; but in the first case, the adoption of the restrictive clauses is *optional* while in the second case it is *obligatory*. It should also be borne in mind that the will of the members remains still important even when the members are obliged by the act to restrict the transfer of the shares. In practice, members always have discretion, within the act, to adopt such clauses as they like and to apply the control prescribed by the act more or less strictly.

I

The Close Corporation as a Creation of the Members

In France and Germany, the joint stock company came into existence towards the end of the nineteenth century. It is a by-product of the machine age. Considerable funds were needed to finance the construction of factories and railways and subscribers had to be attracted by the offer of shares which were easily transferable and could be readily realized by sale at the stock exchange or otherwise;

[2] See p. 546 *supra*.

[3] In France, exceptionally the articles of a société de personnes may authorize a member to dispose of his share to a third party.

those acquainted with the history of company law know that the halcyon days of the company were, to a considerable extent, a time of financial speculation in shares and stock. Today it is well established that the joint stock company has been the main instrument of capitalism.[4] It may, therefore, be surprising, at first sight, that that type of business organization should be utilized as a form of close corporation. The explanation for this phenomenon is that, apart from large public companies which issue prospectuses inviting the public to subscribe to their shares which are quoted on the stock exchange, there exist small corporate enterprises which, though being managed in the form of companies, exhibit all the characteristics of personal associations. Their shareholders want to associate only with relatives or friends; one of the main concerns of the members is to preserve here the intimate character of the association and to prevent the admission of strangers or competitors without their consent. These enterprises are, in fact, personal associations in the guise of *sociétés anonymes.*

It will be seen from the following observations that the statutory regulation applying to the German and French public limited company facilitates, in France, the adaptation of that form of business corporation for purposes of the close corporation, while in Germany the use of the public limited company for those purposes is discouraged and the private limited company (which, in German law, is constituted as a public limited company *en miniature*) is the most suitable form of a close corporation.

A. The French System: The Public Limited Company

In France, the public limited company was introduced by an Act of July 24, 1867. Article 23 of the Act lays down that the company cannot be validly constituted unless the required minimum number of seven members is reached. The Act contains no provision requiring a minimum capital. Consequently, seven persons of slender financial means may validly constitute a *société par actions.* In 1867, the advantages of such form of organization were readily appreciated for at that time the only types of business association recognized by French law were the partnership and the limited partnership. Both are personal associations in which every member has a considerable financial responsibility which is not limited to his contribution. The introduction of the public limited company enabled businessmen to limit their liability to the nominal value of the shares held by them. In view of these evident advantages, it is not surprising that the form of the public limited company became popular not only with large *entrepreneurs* but also with small business people. Since the introduction of the *société à responsabilité limitée* by an Act of March 7, 1925, it has become possible to attain the same economic objects by forming a private limited company; under the Act of 1925, the minimum number of members required for the formation of a private company is only two.[5] However, the private company did not completely supersede the public company as

[4] G. RIPERT, LES ASPECTS JURIDIQUES DU CAPITALISME MODERNE.
[5] Art. 5.

a form of organization of small business in France; the small public company still exists and it is significant, in this connection, that the shares of many French public companies are not quoted at the stock exchange.[6]

It is, therefore, necessary to examine the provisions which the shareholders of a French public limited company may introduce in order to give it the character of a close corporation.

A preliminary remark is called for. As a rule, in the French public company, shares may have two different forms: they may be share certificates which are issued in the name of the shareholders, or they may be share warrants issued to bearer and negotiable by delivery. It is evident that the first step towards attaining close corporateness is to make the shares non-negotiable, *i.e.*, to issue share certificates in the name of the shareholders. The issue of share certificates, while making it possible to identify the member of the company for the time being, is not sufficient to confer the character of a close corporation on the company. The next step is to introduce measures prohibiting the transfer of the shares. Article 50 of the Act of July 24, 1867 is relevant here; that Article provides:

> *Les statuts de la société pourront donner, soit au conseil d'administration, soit à l'assembée générale, le droit de s'opposer au transfert.*

This provision authorizes the introduction, into the articles of association of a public company, of a clause known as the agreement clause (*clause d'agrément*) which provides that no transfer of shares shall be valid unless the board of directors or the general meeting has approved the transferee, but, as will be seen later, in French company law the agreement clause must necessarily be combined with a preëmption clause providing for the payment of a reasonable price for the shares.

The members of a French public company who wish to close their ranks against the admission of strangers will thus achieve their aim by inserting into the articles of association of their company an agreement clause which provides that if a member desires to sell his shares, the board of directors or the general meeting shall be entitled to agree to, or refuse, the admission of the proposed transferee as a member of the company. Such agreement clauses are used in companies of the family type which wish to preserve their character. These clauses are also found in companies of a semi-political character, *e.g.*, companies the objects of which are the publication of reviews or newspapers.[7] The clause under discussion prevents the infiltration of competitors or other persons who might join the company for the purpose of obtaining information as regards its business or even attempting to disorganize it. The agreement clause is an efficient instrument enabling the company to "screen" proposed shareholders and to reject undesirables.

Where the directors or the general meeting accept the proposed transferee, there

[6] In the Netherlands, where no form similar to the *société à responsabilite limité* exists, the *société par actions* is often used as the form of organization of a close corporation.

[7] Cf. for instance: Paris, Nov. 21, 1950, REV. SOC. 172 (1951). In this case, the *Société des Journaux et Imprimeries de la Gironde* and the *Société Damour Publicité* were concerned.

is no difficulty whatsoever. But what happens if their decision is in the negative? The member will then be unable to leave the company. He is a prisoner of his share. Here a great principle of the French law of corporations comes into operation: the right of leaving the company by selling one's share is one of the *droits individuels* of which the member cannot be deprived.[8] Such individual rights of membership are inviolable; they are the minimum protection to which the member is entitled.

Consequently, the French courts have rejected an agreement clause in its pure and unqualified form because it would, in fact, submit a member who wishes to quit the company to the arbitrary veto of the other shareholders.

It is, therefore, necessary, in the eyes of the French law of corporations, that provision should be made enabling the member to leave the company if he so desires. This is done by adding a *preëmption* clause to the agreement clause. The preëmption clause provides that the board of directors or the general meeting, if refusing to consent to the transfer of shares to the proposed transferee, shall nominate another person as transferee.

If a preëmption clause is added, the right of the shareholder to leave the company is preserved. The French courts have further safeguarded the right of the shareholder by ruling that the preëmption clause can be validly exercised only if the price which is payable to the transferor is a "just price," *i.e.*, a price corresponding to the actual value of the shares.[9]

B. The German System

In German law, capital associations are divided into two types, *viz.*, the public limited company (*Aktiengesellschaft*) and the younger form of the private limited company (*Gesellschaft mit beschränkter Haftung*); these types of companies closely correspond to those adopted by English company law.[10]

1. *The German Public Limited Company*. The German concept of the public company does not make it as easy as its French counterpart to realize the aim of close corporateness. The explanation is simple: in France, people of slender financial resources can constitute a public company since the Act of 1867 does not require a minimum capital; that, as has been seen, is the reason why many small public companies are in existence in this country. In Germany, on the other hand, the historical evolution of company law has made it impossible to form small public companies.

A German Act of July 5, 1934 (called the *Umwandlungsgesetz*) aimed at the conversion of companies into partnerships.

[8] This right is founded on Arts. 1, 2, and 24 of the Act of 1867 and Arts. 35 and 36 of the Code de Commerce; cf. René David, *La protection des minorités dans les Sociétés par actions*, THÈSE PARIS, No. 114 (1928).

[9] Cass. civ., Feb. 9, 1937 (2° espèce), note, P. CORDONNIER, JOUR. SOC. 266 (1937). Cass. req. September 11, 1940 (D. C. 1942 i. 116); Cass. req. Nov. 16, 1943 (JCP 1944, II-2589, note Bastian); Paris, June 1, 1950 (JCP 1950-II-5687); Trib. Com. Seine, June 28, 1950 (JCP 1950-II-5772). Adde: J. Molierac, *Des clauses d'égalisation, d'agrément, de préemption*, REV. SOC. 241 (1949).

[10] J. VON GIERKE, HANDELSRECHT, 6. Auflage, S. 357 (§50-III) and S. 227 (§39-IV).

This Act represents a reaction against the extraordinary growth of public companies in Germany in the period following the First World War. In spite of the reduction of her territory the number of public companies rose in Germany between 1913 and 1924 from 5,139 to 17,000.[11] In that period of political and economic instability, German business showed a marked tendency to limit its liability as far as possible. The Nazis did not favor this development of the capitalist mind and, in 1934, passed the *Umwandlungsgesetz* in order to induce public companies to convert their business into personal associations. But the Nazis went further: by the *Aktiengesetz* of January 30, 1937 the small public company was virtually eliminated by the requirement of a minimum capital of 500,000 RM[12] for companies incorporated under the Act and 100,000 RM for companies already in existence when the Act was passed. Small public companies trading with a capital below 100,000 RM were compelled either to convert their business into personal associations in accordance with the procedure laid down in the Act of 1934 or to wind up. The German Companies Act of 1937 thus pronounced sentence of death on the small companies.[13]

In the result, since 1937 it is extremely difficult to use the form of the public limited company in Germany for purposes of close corporateness. But a restriction of the free transferability of shares in public companies is still possible in Germany and is used when the controlling shareholders wish to perpetuate their controlling interest.

In Germany, the public company has two boards, *viz.*, the *Vorstand* which is the board of managing directors, and the *Aufsichtsrat* which is the supervisory organ of the company. Under the Act of 1937, a public company may insert into its articles a clause requiring the consent of the *Vorstand* or of the *Aufsichtsrat* to the transfer of the shares of the members.[14] The consent may be given before or after the transfer[15] and can be requested by the purchaser or the seller.

The restriction of the transfer of shares may be inserted in the original articles of association of the company or may be added later on by an alteration of the articles.[16]

Once given, the consent of the requisite board is irrevocable.[17]

The articles of association may provide that the consent to transfer the shares

[11] SCHLEGELBERGER, DEUTSCHE JUSTIZ, S. 1649 ff. (1936). Adde: BÖTTCHER-MEILICKE, KURZER ÜBERBLICK ÜBER DIE UMWANDLUNGSGESETZGEBUNG, II, 1.

[12] 500,000 DM since the revalorization of July 21, 1948.

[13] ERNST BECHER, AUFBAU, ORGANISATION UND UMWANDLUNG DER AKTIENGESELLSCHAFT NACH DEM AKTIENGESETZ VOM JAN. 30, 1937, THÈSE KÖLN, 1938.

[14] Sec. 61 AGs. III; the shares are then referred to as "gebundene Namensaktien" or "vinkulierte Namensaktien"; H. Küsters, in BANK ARCH. S. 175 (1937). W. HEFERMEHL, DENKSCHRIFT ZUR REFORM DES AKTIENRECHTS (S. 40), Düsseldorf (Nov. 1952).

[15] See §182 ff. of the German Civil Code; 132 RGZ 157.

[16] GADOW-HEINICHEN-E. SCHMIDT-W. SCHMIDT-WEIPERT, KOMMENTAR ZUM AKTIENGESETZ, §61 Anm. 10 (1939); RITTER, KOMMENTAR ZUM AKTIENGESETZ, §61 Anm. 5b (1939); *contra:* 68 RGZ 112; SCHLEGELBERGER-QUASSOWSKI-HERBIG-GESSLER-HEFERMEHL, KOMMENTAR ZUM AKTIENGESETZ, §61 Anm. 6 (3d ed. 1939).

[17] RG in HRR 1933, 45.

can only be refused by the company on "serious grounds"; such grounds may be stated in the articles and a shareholder who intends to sell his shares may bring an action against the company if he thinks that the refusal of the company to the proposed transfer is unjustified.[18]

If the members of the German public company introduce clauses to that effect into the articles of association, the company would qualify as a close corporation.

2. *The German Private Limited Company.* The German private company is better suited to constitute a close corporation than the German public company. The German private limited company is, in fact, a small public company; it is called by German jurists an *"intimer Kapitalverein."* The shares are excluded from dealings at the stock exchange[19] and the minimum capital is 20,000 DM.

The statutory provisions governing the transfer of shares in a German private limited company correspond to those applicable to the transfer of shares in public companies. The reason for this coincidence is that in German corporation theory the private company is derived from the public company.

On principle, the shares in the German private company are freely transferable but the Act of April 20, 1892 which created the German private company, provides in Section 15(5) that the articles may require the shares to be subject to the approval by the company:[20]

> *Durch den Gesellschaftsvertrag kann die Abtretung der Geschäftsanteile an weitere Voraussetzungen geknüpft, insbesondere von der Genehmigung der Gesellschaft abhängig gemacht werden.*

The articles may provide that the consent of the board of directors or of the general meeting shall be required for the transfer of the shares.[21] It is for the company to decide which of these possibilities it prefers. If the transfer is refused, the member cannot bring an action against the company.[22] The consent may be given before or after the transfer and is not subject to any formalities. In order to simplify the procedure, the articles may provide in what cases the transfer may be accepted or refused. The articles may make the transfer more difficult by requiring unanimity of the members for the consent. But the consent given by the *Board* is binding on the company even though the articles require the *members* to consent to the transfer of shares.[23] If the original articles of association do not contain provisions restricting the transferability of the shares, restrictive clauses can later be introduced by an alteration of the articles.[24] The articles may even completely exclude the transferability of the shares.[25]

[18] BAUMBACH-HUECK, KOMMENTAR ZUM AKTIENGESETZ, §62 Anhang. No. 1 (6th ed. 1949).

[19] 149 RGZ 385.

[20] VOGEL, KOMMENTAR ZUM GMBH-GESETZ, §§86 and 87 (1950); BAUMBACH-HUECK, KOMMENTAR ZUM GESETZ BETREFFEND DIE GESELLSCHAFT MIT BESCHRÄNKTER HAFTUNG, §§60 to 63 (5th ed. 1951). Adde: SPINDLER, DER UNERWÜNSCHTE GESELLSCHAFTER, RUNDSCHAU FÜR GMBH, §165 (Nov. 15, 1951).

[21] Some difficulties arise when the articles provide for the consent to the transfer to be given by the company without further specification: OGH Ziv. Band 3, §§90-97.

[22] 88 RGZ 325.

[23] 104 RGZ 414.

[24] 68 RGZ 211.

[25] FEINE, GMBH, 377.

In Portugal,[26] Austria,[27] and Italy[28] the restrictions on the transfer of shares in the private company are governed by provisions similar to those applying to the German private company.

II

THE CLOSE CORPORATION AS A STATUTORY CREATION

A. The French Private Limited Company

In some countries the close corporation concept is directly created by obligatory statutory provisions and does not come into existence as the result of the discretion of the members who make use of facilities placed at their disposal by the relevant statute.

The prototype of this regulation is the French private limited company.

The private limited company was introduced in France by the Act of March 7, 1925. Article 22 of the Act provides with respect to the transfer of shares to persons other than members:

> *Les parts sociales ne peuvent être cédées à des tiers étrangers à la société qu'avec le consentement de la majorité des associés représentant au moins les trois quarts du capital social.*

Under this Article the members are obliged to control the transfer of shares to a stranger. The French private limited company thus emphasizes the close corporateness concept strongly; this is understandable because it was the aim of the promoters of the Act that the *société à responsabilité limitée* should be used by family businesses or small traders who wished to avail themselves of the benefit of limited liability when combining in trade with their relatives or friends.[29] In practice, this type of company is very popular in France and widely used.[30] It is quite simple to form a private limited company in France: not more than two persons are required and the minimum registered capital is 50,000 francs (the value of a typewriter!). In most cases the members are relatives or friends and the provisions of Article 22 are regarded as very useful because they enable the members to prevent the intrusion of a stranger when one of the shareholders attempts to sell out his shares in order to leave the company.

The stipulations of Article 22 are compulsory for the members and cannot be abrogated or contracted out in the articles of the company or otherwise. The French courts have held that if the articles of the private limited company authorize a member to transfer his shares freely to strangers, the company ceases to be a private com-

[26] Act of 1901, Art. 6. [27] Act of March 6, 1906, Art. 76. [28] CIV. CODE, Art. 2476.

[29] CHAPSAL, J. SÉNAT., DÉBATS PARLEMENTAIRES 117 (1925).

[30] In 1949, in the area of the Department of the Seine, there were 7293 sociétés à reponsabilité limitée out of 7805 associations created that year. In 1952 the statistics of associations created and registered at the office of the clerk of the Tribunal of Commerce at Bordeaux were the following:

sociétés en nom collectif	25
sociétés en commandite simple	2
sociétés en commandite par actions	0
sociétés anonymes	23
sociétés à responsabilité limitée	147

pany and would, in fact, be a public company; but since it does not comply with the provisions of the Act of 1867 which regulates public limited companies,[31] such company is regarded as null and void in French law.[32]

Close corporateness is thus so much stressed in the French private limited company that in certain cases a member may be compelled to remain in the company against his will; he is, in fact, "chained" to the company as the following example will show.

Article 22 requires a qualified majority for the consent to transfer the shares, *viz.*, a majority in numbers of the shareholders and a three-quarters majority of the registered capital of the company. Suppose, *e.g.*, that a private company has three members and that its capital is divided into 100 shares. If one member holds 90 shares and the two other members 5 shares each, the majority shareholder cannot sell his shares if the other two members refuse to consent; although the majority shareholder satisfies the second requirement, *viz.*, holds more than three-quarters of the registered share capital, he fails to satisfy the first requirement, *viz.*, he does not represent the majority in number of the members.[33] Article 22 thus provides an effective protection against the transfer of shares to a stranger contrary to the will of the majority of shareholders.

If the members refuse to agree to the transfer and are unwilling to purchase the shares themselves, their refusal is definite; it is not subject to appeal to a court or another authority and the member who wishes to sell out is obliged to remain in the company. He is truly in the shackles of the company. Article 22 operates as a statutory mechanism which turns the company into a close corporation; the door of the company is locked and bolted; it opens to a stranger only if it is quite plain that he is welcome to the majority of members.

While the member who desires to leave the company may be its reluctant prisoner, he has, on certain conditions, a drastic remedy at his disposal which enables him to carry out his plan: he may obtain a winding-up of the company. But he can do so only if the company has been constituted for an unlimited period of time and if he acts bona fide, *i.e.*, without any malicious intention to the other members (Articles 1869 and 1870 of the Civil Code).[34]

These observations indicate that the close corporation character is so prominent in the French private limited company that it may lead to the extreme consequence of the liquidation of the company. But the courts still hesitate to wind-up a company in these circumstances and, in practice, the enforcement of Aricles 1869 and 1870 gives rise to many difficulties.[35]

The effect of Article 22 of the Act of 1925 is that a member can never introduce

[31] See p. 549 *supra*.

[32] Paris, Nov. 21, 1951, REV. SOC. 169 (1952).

[33] Cf. A. Peytel, *A propos de la cession des parts dans les sociétés à responsabilité limitée*, GAZ. PAL. 1950-I-Doctrine p. 3, No. VI.

[34] Paris, Dec. 9, 1932 (D. 1934-2-29); HOUPIN AND BOSVIEUX, TRAITE DES SOCIETES, T. II, No. 1618.

[35] Cf., for instance, Trib. com. Rochefort-sur-mer, July 8, 1932 (S. 1933-2-89); Trib. com. Valenciennes, September 5, 1950 (GAZ. PAL. 1950-II-380).

a stranger into a French private limited company by selling his shares to him if the other members object. In that contingency the French private limited company is hermetically sealed against outsiders.

The Swiss private limited company is likewise founded on the close corporation concept. It was introduced into Switzerland by an Act of December 18, 1936.[36] It is closer to the French type of private limited company than to the German type. As far as the transferability of shares in the Swiss private limited company is concerned, provisions apply similar to those governing the shares in its French counterpart: the transfer of shares to third persons must be authorized by a qualified majority of the members, *viz.*, by three-quarters of the members representing three-quarters of the capital.[37] Swiss law is, in that respect, even stricter than French law: in Swiss law the required majority in numbers of the members is three-quarters while in French law the consent of an ordinary majority of members is sufficient. Under the Swiss Act, the members may completely exclude the transferability of the shares by appropriate clauses in the articles of association of the company.[38]

The *société à responsabilité limitée*[39] in Luxemberg and in Belgium the *société de personnes à responsabilité limitée*[40] are governed, with respect to the transferability of shares, by provisions similar to those applying to the French and Swiss private limited company.[41] It is intended to introduce the French type of private limited company into the principality of Monaco.[42]

In all these countries the private limited company strictly conforms to the concept of the close corporation.

III

The following conclusions emerge from this short study in comparative company law: in the legal systems of the continent of Europe the close corporation does not exist as a separate form of business organization. The concept of close corporateness comes into existence at any time when a company limited by shares wants to protect itself against the intrusion of strangers. The technical means by which a company is entitled to turn itself into a close corporation is the same everywhere: the members are not allowed to transfer their shares freely.

Sometimes restrictions on the transfer of shares are optional: members may insert them into the articles of the company if they so desire; examples of this type are the French and German public limited company and the German private limited company. Sometimes those restrictions are compulsory: the members need not lay them down in the articles, they are already contained in obligatory provisions of the governing act; an example of this type is the French private limited company.

[36] OBLIGATIONENRECHT, Art. 772 ff.; GYSIN, FESTGABE FÜR WIELAND, S. 172 ff. (1934); WIDMER, DIE ORGANISATION DER GMBH NACH SCHWEIZERISCHEM RECHT, THÈSE ZÜRICH, 1945.
[37] OBLITATIONENRECHT, Art. 791(2).
[38] OBLIGATIONENRECHT, Art. 791(3).
[39] Act of September 19, 1933, Art. 189.
[40] Act of July 9, 1935, Art. 126.
[41] French Act of 1925, Art. 22; SWISS OBLIGATIONENRECHT, Art. 791.
[42] Art. 18 of the proposed bill; REV. SOC. 189 *et seq.* (1952).

Between these two types of corporate organization, there exists an intermediate one: the English form. The English Companies Act, 1948, requires that the articles of a private limited company shall contain, *inter alia*, restrictions on the transfer of its shares but refrains from defining what restrictions are required.[43]

The close corporation concept exists in Europe, England, and the United States but Anglo-American law is generally very different from continental law. The close corporation concept affects the law of business organizations in every country and it is not surprising that the same answers are given everywhere to the same practical problems and that the various national laws tend to produce similar solutions.

If one day the studies in comparative law are to lead to an internationalization of law, the movement will have to start in business law which is less particularized than family law or succession law where tradition and sentimental prejudice prevail and prevent the different countries from reaching uniform solutions.

[43] Companies Act, 1948, §28(1)(a), 11 & 12 GEO. VI, c. 38. PALMER'S COMPANY LAW 361-362 (19th ed. 1949). The same solution has been adopted in Canada; the Companies Act, 1934, 24 & 25 GEO. V, c. 33.

TAXING THE INCOME OF THE CLOSE CORPORATION

Charles L. B. Lowndes*

Although there is no substantial agreement about how the income from close corporations should be taxed, there appears to be virtual unanimity with respect to the defects of the present system.

The basic weakness of the method adopted by the federal income tax for taxing corporate income is that it is predicated upon a legal fiction which ignores economic realities. In the case of a partnership, the partnership is disregarded and the partners are taxed directly upon their distributive shares of the partnership income.[1] In the case of a corporation, however, the law gives full credence to the corporate fiction. Although in substance a close corporation represents an incorporated partnership, or perhaps an incorporated sole proprietorship, the corporate entity is treated as an independent taxable entity, and the income of the undertaking is taxed to the legal convention, rather than to the real owners of the enterprise.

The recognition of the corporation as a distinct taxable entity has several unhappy corollaries. Even in the case of the publicly owned corporation, it results in a complete disregard of the ability to pay principle, which is supposed to be one of the cardinal *desiderata* of an income tax. Although there is considerable speculation about the actual incidence of the corporate income tax,[2] and whether the burden of the tax is shifted to the consumer in the form of higher prices, or to the corporate employees in the form of lower wages, or to the stockholders in the form of diminished dividends, it is clear that the actual burden of the tax is not imposed upon the corporation, which is a legal fiction. The corporate tax, which in recent years has been graduated according to the size of the corporate income, obviously bears no relation to the wealth or the ability to pay of the person who actually pays the tax, whoever he may be.

In the case of close corporations there are more fundamental objections to the current system of taxing corporate income. Some taxes are unjust because they bear

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[1] The first federal income taxes, passed during the Civil War, taxed the income of corporations in the same way, that is, they ignored the corporate entity and taxed the shareholders directly upon their distributive shares of the corporate income. This system was sustained in Collector v. Hubbard, 12 Wall. 1 (U. S. 1870), although the Supreme Court later repudiated the *Hubbard* case in Eisner v. Macomber, 252 U. S. 189, at 217-219 (1920), declaring that "the stockholder's share in the accumulated profits of the company is capital, not income" (p. 219), and that he realizes no income upon which he may be taxed under the Sixteenth Amendment until the corporate profits are distributed to him in the form of dividends.

[2] Slitor, *Economic Aspects of the Tax on Corporate Income*, Lectures on Taxation of Business Enterprise 28, 32-38 (1951).

too heavily upon a particular class of taxpayers. Others lack equity because they are susceptible to manipulation which makes it possible for the sophisticated taxpayer to shift his legitimate share of the tax burden to some more ingenuous citizen. The corporate tax enjoys the dubious distinction of erring in both directions. Since corporate income is taxed in the first instance to the corporate entity, when it is earned, and again to the stockholders, when it is distributed to them in the form of dividends, while the income of a partnership or a sole proprietorship is taxed but once to the partners or the sole proprietor, the corporate tax discriminates against incorporated partnerships and incorporated sole proprietorships. On the other hand, the recognition of an artificial legal convention as an independent taxable entity is a constant stimulus to tax manipulation and tax avoidance.

The theoretical objections to the present system of taxing the income of close corporations are that it makes the conduct of a business subordinate to tax considerations and interposes an unwarranted impediment to freedom of choice of the form of business organization, because of the double tax on corporate income, as contrasted with the single tax upon the income of a partnership or a sole proprietorship. Moreover, by treating the corporate personality as a distinct taxable entity, the corporate tax serves as a shield behind which the tax dodger may conduct his maneuvers with impunity.

The ultimate test of a tax, however, lies in the practical operation of the tax in a concrete context, rather than its theoretical imperfections. The present system of taxing the income of close corporations must be judged by whether it really does create a genuine obstacle to conducting a business as a corporation rather than a partnership or sole proprietorship, and whether it actually encourages tax manipulation and tax avoidance.

CHOICE OF FORM OF BUSINESS ORGANIZATION: THE CLOSE CORPORATION VERSUS THE PARTNERSHIP OR SOLE PROPRIETORSHIP

It is difficult to determine the precise extent to which the present system of taxing the income of close corporations constitutes a genuine impediment to the selection of the corporate form to conduct a business, which could be carried on as a partnership or sole proprietorship, because the relative tax advantages and disadvantages of various forms of business organization are linked so intimately with the concrete facts of a particular situation. In some cases it may actually be more economical to do business as a corporation. In others, a partnership or a sole proprietorship is preferable from a tax point of view. Unquestionably, the fact that the income of a close corporation is taxed differently than that of a partnership or a sole proprietorship is a predominating factor in the selection of the form of business organization. It is not, however, a consideration which inclines constantly in the same direction, since the tax advantages of one form of organization over another shift continually with changes in the underlying factual situation.

Because the tax advantages of a particular form of business organization are tied so closely to the unique facts of the particular situation, it is impossible to lay down

any rigid rule which can be applied indiscriminately in every case to determine the most economical form of doing business from a tax point of view. It is feasible, however, to point out some of the major tax factors which must be weighed in choosing a form of business organization to illustrate the unwarranted predominance which tax considerations have achieved in this area, because of the identification of the corporation as an independent taxable entity.

A. Rates

A basic consideration in the choice of a corporation or a partnership or sole proprietorship as a form of business organization is the mattter of rates, since corporate income is taxed under a different rate schedule than that applied to individual income, and corporate income is subject to the excess profits tax, which does not apply to other types of income.[3] There is, however, no constant ratio between the corporate tax and the individual tax, since this depends upon such variant factors as the size of the income, the application of the excess profits tax, and the personal status of the individual taxpayer. The recent revenue acts, which have reimposed the excess profits tax and permitted married taxpayers to split their incomes, have tended to favor partnerships and sole proprietorships, rather than corporations, as a form of business organization.[4] However, the actual rate, at which the income from an enterprise is taxed, depends to such an extent upon the unique facts of the particular situation that it is impossible to generalize about which rates are more favorable.

B. Double Taxation

An important factor in determining the actual *effective* rate of tax upon the income of a close corporation is the possibility of avoiding a double tax. If corporate income is taxed first to the corporation, when it is earned, and again to the stockholders, when it is distributed to them in the form of dividends, it is obvious that the aggregate tax upon corporate income will be heavier than that which would be incurred by a partnership or a sole proprietorship. In many cases, however, it is possible to eliminate the double tax. In a given situation it may even be possible to divide the income from an incorporated enterprise between the corporation and the individual entrepreneurs, so that part of the income is taxed to the corporation and part to the individual shareholders, with a lower aggregate tax than if it were all taxed directly to the individual owners of the business.

As a general rule, if the corporate profits can be distributed to the stockholders in a form which is deductible from the corporate income, a business may be conducted as a corporation about as economically from a tax point of view as a partnership, because of the elimination of any additional corporate tax. Thus, many

[3] Individual rates range from 22.2 to 92 per cent; corporate rates, including the excess profits tax, from 30 to 82 per cent.

[4] The lowest corporate rate is higher than the highest individual rates in the case of a married person whose net income (before exemptions) is less than $14,000, a single person whose net income is less than $7,000, and the head of a household whose net income is less than about $12,000.

small enterprises, whose earnings are derived chiefly from the efforts of the owners of the business, are able to operate as corporations without any undue tax penalty, because they can distribute their profits in the form of salaries, which are deductible from the corporate income. In fact, if part of the corporate earnings are plowed back into the business for expansion, it may be more economical to operate as a corporation than a partnership. In the case of a partnership, all of the partnership income is taxed to the partners, regardless of whether it is distributed to them or retained in the business. There is, therefore, no opportunity to divide the income from the business between the partners and the firm. In the case of a corporation, however, if part of the corporate income can be distributed to the shareholders in the form of salaries, or other items deductible from the corporate income, and part can be retained in the corporation, it is possible to divide the income from the enterprise between the corporation and the stockholders, so as to take advantage of the lower brackets under both the corporate and individual taxes.

Of course, matters may not work out so neatly. The deduction for salaries is limited to reasonable salaries, or in the words of the statute to "a reasonable allowance for salaries or other compensation for personal services actually rendered."[5] Moreover, there are restrictions upon the earnings which a corporation may retain without encountering the surtax under Section 102, which is imposed as a penalty upon a corporation" formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, though the medium of permitting earnings or profits to accumulate instead of being divided or distributed."[6] The limitation upon the deduction for salaries to reasonable salaries may create an awkward situation, if the particular stockholder needs a greater portion of the earnings of the business than can properly be regarded as reasonable compensation for the services which he renders to the corporation. Furthermore, in order to accumulate earnings in the corporation without incurring the Section 102 surtax, there must be some showing that they are needed for expansion or some independent business purpose of the corporation.[7]

Salaries or compensation for personal services are not the only items which may be deducted from corporate income. Although dividends distributed by a corporation are not deductible in computing the corporate tax, the interest which a corporation pays on its debts is. Consequently, it has become customary to finance a corporation largely with borrowed capital in order to distribute the corporate earnings in the form of interest upon its obligations, which is deductible from the corporate

[5] INT. REV. CODE §23(a)(1)(A). Section 23(c) of the Code forbids the deduction of expenses (including salaries) and interest incurred by a corporation on the accrual basis in favor of a stockholder on the cash basis, who owns, directly or indirectly, more than 50 per cent in value of the corporate stock, unless the deductible item is paid within the taxable year, or two and one-half months from the close of the taxable year.

[6] INT. REV. CODE §102(a).

[7] For an interesting attempt to appraise the impact of the Section 102 surtax upon the conduct of a business in the corporate form, see ECONOMIC EFFECTS OF SECTION 102 (1951), a questionnaire and panel investigation conducted under the direction of the panel committee of the Tax Institute, Incorporated.

income.[8] Although borrowed capital is treated less favorably than equity capital under the excess profits tax, there are a number of advantages in financing a corporation with borrowed capital, or what is popularly called "thin incorporation."[9] In addition to deducting the interest paid on the obligations of the corporation, it is possible to retain substantial amounts of the corporate earnings in the corporate treasury to fund its indebtedness without incurring the Section 102 surtax. Moreover, the corporation can distribute its earnings by redeeming its bonds, or paying off its debts, without subjecting such payments to an additional tax in the hands of the stockholder-creditors, where a similar distribution in redemption of part of its stock would run the risk of being taxed as an ordinary dividend under Section 115(g).[10]

While thin incorporation has its advantages, there is a still unsettled problem as to just how thin incorporation can get before the Commissioner can see through it.[11] It has been held that if the borrowed capital is substantially disproportionate to the equity capital, the borrowed capital will be treated as equity capital and a deduction for interest paid on the borrowed capital will be disallowed.[12] Moreover there appears to be no manifest reason why the redemption of bonds in such a case could not be taxed under Section 115(g) as an ordinary dividend.[13] It is obvious that while it may be possible to eliminate a corporate tax by paying out corporate earnings in the form of interest rather than dividends, the restrictions on thin incorporations, like

[8] In an endeavor to create obligations which from the corporation's point of view have the advantages of stock, but which will be treated taxwise as debts, corporations have resorted to "hybrid securities," which in practice have proved very difficult to classify as stock interests or debts. See John Kelley Co. v. Commissioner, 326 U. S. 521 (1946); Wetterau Grocer Co., Inc. v. Commissioner, 179 F. 2d 158 (8th Cir. 1950); Commissioner v. Schmoll Fils Associated, Inc., 110 F. 2d 611 (2d Cir. 1940); United States v. South Georgia Ry., 107 F. 2d 3 (5th Cir. 1939); Helvering v. Richmond, F. & P. R. R., 90 F. 2d 971 (4th Cir. 1937).

[9] See Schlesinger, *"Thin" Incorporations: Income Tax Advantages and Pitfalls*, 61 HARV. L. REV. 50 (1947).

[10] Ordinarily the redemption of stock is treated as a sale of the stock by the stockholder to the corporation, and the stockholder's taxable income is limited to the excess of the redemption price over his basis for the stock. Usually, moreover, any such excess will be taxed as a long-term capital gain. To prevent corporations from distributing their earnings under the guise of a partial liquidation, Section 115(g)(1) of the Code provides that if a corporation "cancels or redeems its stock . . . at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed" shall be taxed as an ordinary dividend to the extent that it represents a distribution of taxable surplus. It is argued that Section 115(g)(1) has no application to the payment of debts or the redemption of bonds because it refers in terms to the cancellation or redemption of "stock."

[11] Note, *Loan Versus Investment—Inadequate Capitalization*, 5 TAX L. REV. 424 (1950); Bryson, *Stockholder Loans: Thin Capitalizations*, 8 N. Y. U. TAX INST. 732 (1950); Semmel, *Tax Consequences of Inadequate Capitalization*, 48 COL. L. REV. 202 (1948).

[12] Dobkin v. Commissioner, 192 F. 2d 392 (2d Cir. 1951); Sogg v. Commissioner, 194 F. 2d 540 (6th Cir. 1952); Schnitzer v. Commissioner, 183 F. 2d 70 (9th Cir. 1950); Swoby Corporation v. Commissioner, 9 T. C. 887 (1947); Janeway v. Commissioner, 147 F. 2d 602 (2d Cir. 1945). For cases where there appeared to be a substantial disproportion between equity and borrowed capital, however, and the borrowed capital was still treated as a debt, see Spreckels v. Commissioner, 8 T. C. M. 1113 (1949); McDermott v. Commissioner, 13 T. C. 468 (1949) (A).

[13] See Stein v. Commissioner, 46 B. T. A. 135 (1942) where in holding that payments on a note issued by a corporation to its stockholders were taxable to the stockholders as ordinary dividends, the Board suggested Section 115(g) as an alternative ground of decision.

the limitation upon the deduction of salaries, make this a matter calling for skillful and sophisticated tax management.

In addition to the distribution of corporate earnings in the form of salaries and interest to minimize or eliminate the corporate income tax, part of the corporate profits are frequently paid out in the form of rent, which the corporation can deduct from its income as a business expense. Under this scheme, the stockholders will retain title to the property which the corporation needs to operate its business and lease it to the corporation, so that the rent paid by the corporation can be deducted from its income. Here again, however, caution must be exercised. If the rent paid by the corporation is in excess of the fair figure which would have been fixed in an arm's length transaction, the excess above the fair rental value of the property will be disallowed as a deduction.[14] It seems possible, moreover, that if the lease simply represents a scheme for diverting income from the corporation and serves no independent business purpose of the corporation, any deduction for rent may be disallowed, while the rent itself may be taxed to the stockholder who receives it as a dividend.[15]

C. Tax-Exempt Income; Capital Gains

In addition to the effective rates of tax upon the income of an enterprise conducted as a corporation and as a partnership, there are other differences between the ways in which corporations and partnerships are taxed, which follow as more or less logical corollaries from the recognition of the corporation as a distinct taxable entity, and which must be taken into account in the choice of a form of business organization. One of these differences, for example, is the way in which tax-exempt income of a corporation and of a partnership is treated.

Tax-exempt income of a partnership does not lose its tax-exempt status when it is taxed to the partners, since the partnership is merely a conduit for allocating the partnership income to the partners. Tax-exempt income of a corporation, however, is transmuted into taxable income when it passes through the hands of the corporation and is distributed in the form of dividends, since the exemption is lost by the interposition of an independent taxable entity between the income and the stockholders.[16] The moral, of course, is plain. Tax-exempt or partially tax-exempt income should

[14] Int. Rev. Code §45; U. S. Treas. Reg. 111, §29.45-1. See Welworth Realty Co. v. Commissioner, 40 B. T. A. 97 (1939) (A).

[15] In 58th Street Plaza Theatre, Inc., 16 T. C. 469 (1951), *aff'd*, 195 F. 2d 724 (2d Cir. 1952), a family corporation, which owned a valuable lease on a motion picture theater, sub-leased the theater to a minority stockholder, the wife of the majority stockholder, who proceeded to hire her husband to operate the theater for her. The court found that this arrangement was simply designed to divert income from the corporation to reduce taxes and served no independent business purpose of the corporation, and held that the profits from the operation of the theater were taxable to the corporation as a part of its income and also to the wife as a dividend. Incidentally where property is leased by a corporation to a stockholder (as distinguished from a lease by a stockholder to the corporation) in addition to the risk that the transaction may not stand up taxwise, the rent received from the stockholder will be personal holding company income, if the stockholder owns directly or indirectly 25 per cent or more of the corporate stock, and may subject the corporation to the personal holding company surtax.

[16] U. S. Treas. Reg. 111, §29.115-3; Charles F. Ayer v. Commissioner, 12 B. T. A. 284 (1928).

not be given to a corporation, but should, as far as practicable, be retained by the individual stockholders.

The fact that income may change its character between the time it is earned by a corporation and distributed to the stockholders does not, however, always work to the disadvantage of the stockholders. It is sometimes possible to convert ordinary income of a corporation into a long-term capital gain in the hands of a stockholder by liquidating the corporation. Incidentally, however, there is no profit in transferring capital assets, which have increased in value, to a corporation with the idea of having the corporation sell the assets and realize the gain, since the minimum tax which a corporation must pay upon such a gain is 26 per cent, which is the maximum tax which an individual may pay, and he may pay less.[17] Moreover, if the gain realized by the corporation is ultimately distributed to the stockholder it will be taxed to him again, and, unless the distribution occurs in connection with a liquidation of the corporation, taxed as ordinary income.

D. Deferring Gains and Losses

One of the advantages of conducting an expanding business as a corporation, which was noted earlier, is that the earnings which are retained by the corporation may be kept out of the incomes of the stockholders and taxed to the corporation in a lower bracket than they would be taxed to the stockholders. In other words, this is a possible way of dividing the income of a business between the corporation and the proprietors of the business and taking advantage of the lower brackets of both the corporate and individual taxes. On the other hand, if a business is conducted as a partnership or a sole proprietorship, all of the income of the business will be taxed to the partners or to the sole proprietor, regardless of whether it is actually distributed to them or plowed back into the business.

Conversely, however, it may be advantageous to organize a new business, in which losses are anticipated in the early years, as a partnership or sole proprietorship, rather than a corporation, since the losses incurred in starting the business can be utilized directly by the partners or the sole proprietor to offset their gains from other sources, and if they arise from the operation of the business, as distinguished from the sale or exchange of capital assets, they will be fully deductible as ordinary business losses. If, on the other hand, the business is conducted as a corporation, any losses incurred in the operation of the business will be the losses of the corporation and cannot be availed of by the stockholders. Although such losses may give rise to a net operating loss which can be carried over and offset against the profits of later years, if the corporation continues to be unsuccessful and realizes no gains the carry-over cannot be utilized either by the corporation or the stockholders. Moreover, although the stockholders will realize a loss when the corporation is finally

[17] Long-term capital gains realized by a corporation are taxed at 26 per cent. The tax on a long-term capital gain in the case of an individual cannot exceed 26 per cent. If, however, it will result in a lower tax, an individual may pay a tax on 50 per cent of the gain at the regular rates, so conceivably the individual tax on a long-term capital gain may be as low as 50 per cent of 22.2 per cent (the lowest individual bracket) or 11.1 per cent.

liquidated, the loss will ordinarily take the form of a long-term capital loss subject to the restrictions on such losses.

E. Organization and Liquidation

Although theoretically a corporation should pay a heavier tax than a partnership or a sole proprietorship, because corporate income is exposed to the hazard of a double tax, actually the tax burden of a close corporation depends upon a number of adventitious circumstances. Moreover, the circumstances which determine the relative tax advantages of doing business under the corporate form are not static but are subject to constant fluctuation. At one stage in the existence of a business, it may be profitable to operate as a corporation, and at another, as a partnership or sole proprietorship. Not only changes in the fortunes of the business, but changes in the law, such as the enactment or repeal of an excess profits tax, permission for married taxpayers to split their incomes, and upward and downward revisions in the corporate and individual rate schedules, may make a change in the form of business organization imperative. In this connection it is important to bear in mind that it is much easier to shift into a corporation than it is to shift out of one.

A partnership can be organized or liquidated without realizing taxable gain or loss.[18] Moreover, a partnership can be converted into a corporation without incurring any gain or loss, if the partners are in control of the corporation after the transfer of the partnership assets to the corporation, and they retain the same proportionate interests in the corporation, which they had in the partnership property.[19]

[18] No gain or loss is recognized on the organization of a partnership, but any property contributed by the partners takes as its basis, in the hands of the partnership, the basis which it had in the hands of the contributing partner. INT. REV. CODE §115(13). When a partnership dissolves and distributes property to the partners, no gain or loss is realized, but the basis of the property in the hands of a partner is a proportionate part of the basis for his interest in the partnership. *Ibid.* If the partnership distributes cash this reduces the basis of the partners' interests in the partnership, but taxable gain will not be realized by the partners unless the cash distributed exceeds the basis of their partnership interests. The realization of any gain upon the dissolution of a partnership can ordinarily be avoided by having the partnership distribute any cash it may have on hand first, and then its other assets. Unless the cash exceeds the basis of the partners' interests, it will simply reduce the basis of their interests, and upon the distribution of the partnership's other assets, the remaining basis of the partners' interests will be allocated among them and there will be no taxable gain.

[19] INT. REV. CODE §112(b)(5). Gain or loss is not realized where property is transfererd to a controlled corporation solely in exchange for stock or securities in the corporation, and, if the transfer is by two or more persons, the amount of stock or securities received by them is substantially in proportion to their interests in the transferred property prior to the transfer. "Control" is defined as "the ownership of stock possessing at least 80 per centum of the total combined voting power of all classes of stock entitled to vote and at least 80 per centum of the total number of shares of all other classes of stock of the corporation." INT. REV. CODE §112(h).

Since in the case of a tax-free incorporation, the stock or securities in the hands of the transferor takes as its basis the basis of the transferred property and the assets transferred to the corporation have the same basis to the corporation which they had in the hands of the transferor, it is sometimes profitable to make a taxable, rather than a tax-free, transfer to the corporation. For example, suppose that *A* and *B* are partners who own a patent which has 20 years to run, whose fair market value is $100,000, and whose basis to *A* and *B* is zero. If they transfer the patent to a corporation by a tax-free transfer, they will realize no income, but the corporation cannot deduct any amortization in connection with the patent, since it has a zero basis. If, however, *A* and *B* make a taxable transfer to the corporation for $100,000 in cash, or stock or securities, worth $100,000, they will realize a taxable gain of $100,000. Assuming, however, that the gain is taxed as a long-term capital gain under section 117(j) of the Code, the maximum tax on the gain will be at 26 per cent or $26,000. The patent now has

The recognition of the corporation as a distinct taxable entity, however, usually makes it impossible to liquidate a corporation and shift to a partnership without serious tax consequences. A common situation which frequently causes embarrassment in this connection is where it becomes necessary to liquidate an incorporated business which has built up a substantial good will. To take a typical case, suppose that *A* and *B* each invested $50,000 in a soft drink business, which they operated as partners. The business was unusually successful and they decided to incorporate it, which they did by transferring the partnership assets to a newly organized corporation in exchange for all of its stock. Later an excess profits tax was passed, and *A* and *B* discovered that they could only withdraw a fraction of the corporate earnings, which they needed to live in the style to which they had become accustomed, as reasonable salaries which were deductible from the corporate income. It became apparent that the cost of doing business as a corporation was prohibitive, so *A* and *B* decided to liquidate the corporation and re-convert to a partnership. They had the corporation redeem their stock in exchange for the corporate assets, which they proceeded to convey to a partnership. Everything went smoothly until the tax collector stepped in and decided that the value of the business was $1,000,000, allowing $900,000 for good will, and that *A* and *B* had realized a capital gain of $900,000 when they exchanged their stock (which had a basis of $100,000, their original investment) for the corporate assets, on which the minimum tax was $234,000.

Of course, the fact that gain or loss is recognized when a corporation liquidates may work to the advantage of the taxpayer. For example, suppose that a corporation has an inventory which it purchased for $50,000 and which has a fair market value of $100,000. If the corporation continues in business and sells the merchandise in its inventory it will realize ordinary income of $50,000 upon which the tax might be as high as 82 per cent or $41,000. If, however, the corporation liquidates and distributes its inventory to redeem stock having a basis of $50,000, the stockholders will realize a long-term capital gain of $50,000, on which the maximum tax will be

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a basis of $100,000 in the hands of the corporation, which can deduct that sum by way of depreciation over a 10 year period. Assuming a corporate tax of 82 per cent there is a net saving of $56,000. In this connection, it is important to notice, however, that the 1951 Act provides that gains from sales or exchanges of depreciable property between an individual and a corporation, in which he or his spouse, minor children, or minor grandchildren own more than 80 per cent in value of the outstanding stock, shall be taxed as ordinary income. INT. REV. CODE §117(o), added by §328, 1951 Act. Consequently, in the hypothetical case, if *A* and *B* were husband and wife, or father and minor son, who together owned more than 80 per cent of the stock in the corporation to which they made a taxable transfer of the patent, the gain from the transfer would be fully taxable as ordinary income. If, however, *A* and *B* were brothers and neither one owned more than 80 per cent of the stock of the corporation, their gain upon the transfer would still be taxable as a long-term capital gain.

A partnership may be incorporated tax-free either by having the partnership transfer its assets to the corporation in return for its stock and securities, which the partnership then distributes to the partners, or by having the partnership dissolve and distribute its assets to the partners, who then transfer the assets to the corporation. The form which is followed may have an important effect on the basis of the assets in the hands of the corporation, since any assets transferred directly by the partnership to the corporation will take as their basis in the hands of the corporation, the basis which they had in the hands of the partnership; while assets distributed first to the partners and transferred by the partners to the corporation, will take as their basis a proportionate part of the basis of the partners' interests in the partnership.

26 per cent or $13,000. However, the inventory in the stockholders' hands will have a stepped up basis of $100,000 so they can transfer the property to a partnership, which can sell it for $100,000 without realizing any further gain.

Some other difficulties may be encountered in connection with the liquidation of a corporation which do not occur upon the dissolution of a partnership. If the owners of a corporation wish to sell the corporate assets, which have appreciated in value, the proper procedure is to liquidate the corporation and distribute the assets to the stockholders and have the stockholders sell the assets, instead of having the corporation sell its assets and distribute the proceeds of the sale to the stockholders. If the sale is consumated by the corporation, the corporation will realize a gain from the sale which will be taxed to the corporation, and the stockholders will have additional taxable income when the proceeds of the sale are distributed to them. Theoretically, however, if the assets are distributed to the stockholders who make the sale, the only taxable gain, which will be incurred, will be a long-term capital gain (the difference between the fair market value of the assets distributed to the stockholders by the corporation and the basis of their stock) at the time the assets are distributed to the stockholders. In the hands of the stockholders, the corporate assets will take as their basis the fair market value of the assets at the date of distribution, and since presumably this will approximate the figure at which the assets are sold by the stockholders, no further gain will be realized on the sale. In this connection, however, the Treasury has manifested a stubborn inclination to regard the stockholders as the agents of the corporation in selling the corporate assets and to treat the sale by the stockholders as a sale by a corporation and a distribution of the proceeds of the sale to the stockholders. The Treasury has some judicial backing for its position and the cases are inconclusive and unsatisfactory.[20] This is, of course, a problem which does not arise in the case of a partnership, where there will be only a single tax regardless of whether the partnership sells its assets and distributes the proceeds to the partners or distributes its assets to the partners who sell them.[21]

The moral is plain. It is wise to proceed with caution in incorporating a business. Before the decision to incorporate is made, the possible tax consequences if it be-

[20] Compare the decisions of the Supreme Court in Commissioner v. Court Holding Co., 324 U. S. 331 (1945) and United States v. Cumberland Public Service Co., 338 U. S. 451 (1950). See Gutkin and Beck, *Sale of Assets Received on Liquidation*, 28 TAXES 328 (1950); Note, *Sale of Stock or Purchase of Assets*, 4 TAX L. REV. 378 (1949); Seghers, *Purchase and Sale of a Business or Its Assets*, 26 TAXES 1165 (1948); Magill, *Sale of Corporate Stock or Assets*, 47 COL. L. REV. 707 (1947).

[21] Where a partnership sells only part of its assets, however, it may make a considerable difference taxwise whether the assets are sold directly by the partnership, or are distributed to the partners and sold by the partners, because of the effect on the basis of the assets. For example, suppose that *A* and *B* organize *AB* company, each contributing $50,000 which remains the basis for their respective interests in the partnership. *AB* company purchases 1,000 shares of *X* Corporation stock for $50,000 which increase in value to $100,000. Assuming that the fair market value of all *AB* company's assets are $150,000, if the partnership sells the *X* stock for $100,000 the partners will realize a capital gain of $50,000, or $25,000 apiece. If, however, the *X* stock is distributed to the partners and sold by the partners for $100,000 their taxable gain will only be $33,333.00 or $16,666.67 each, since the basis of the stock in their hands would be $66,666.67 $\left(\frac{100{,}000 \times 100{,}000}{150{,}000}\right)$.

comes necessary to liquidate later should be carefully considered. Incidentally, incorporation has a fatal fascination for the average lawyer who is not versed in tax matters. Incorporation should not be undertaken without consulting a tax expert and carefully mulling over the possible tax consequences, not only in the immediate future, but at some more distant time when changes in the business or the tax law may make it desirable to shed the corporate form.[22]

F. Some Miscellaneous Considerations

In choosing a form of business organization, there are a number of minor tax considerations, which, although seldom controlling, operate as make-weights in a final decision. In this connection, state as well as federal taxes must be taken into account. Ordinarily, a corporation pays a franchise tax for the privilege of doing business in the corporate form, to which a partnership is not subject.[23] Moreover, there is usually a fee for incorporation, which does not apply to a partnership, as well as various taxes upon the issuance and transfer of stock, which have no application to a partnership. Although the costs of incorporating a small corporation are usually nominal, they are factors to be weighed in the balance of a final judgment.

The excess profits tax, which may or may not have lapsed before this article is published, applies to corporations, but not to partnerships or sole proprietorships. Moreover, since the stockholders who work for a corporation are treated as employees of the corporation, while working partners are regarded as proprietors, there are differences in social security taxes between a partnership and a corporation.[24]

[22] The principal purpose of this brief discussion of organization and liquidation of a business has been to illustrate the arbitrary impact of the conception of the corporation as a distinct taxable entity upon the taxation of close corporations and partnerships. Some technical considerations which have not been considered because their inclusion in a discussion of this type scarcely seemed to warrant the detail involved, are the effect of switching from one form of business organization to another upon (1) the credit for the excess profits tax and the excess profits tax ceiling on new businesses; (2) carry-over and carry backs of net operating losses; (3) the disallowance of deductions; (4) bunching income in a single taxable period; and (5) the transfer of life insurance policies. Moreover, no consideration has been given to the selection of a taxable year for a new form of business organization and whether it is wiser to liquidate during or at the end of a taxable year.

[23] However, some states impose taxes on unincorporated business as well as corporations. On the other hand, some states have a corporate income tax, but no individual income tax. Moreover, a corporation which seeks to do business outside the state of its incorporation may have to qualify or incorporate in the foreign state, where it seeks to do business, while there is usually no similar requirement in connection with a partnership. The effect of state taxes upon the form of business organization may be neutralized to some extent, however, by the fact that they are deductible from the federal income tax.

[24] The tax for old age benefits in the case of the stockholder employee is 3 per cent of his salary (up to $3,600), which takes the form of a payroll tax of 1.5 per cent and a tax on wages of 1.5 per cent. Moreover, the stockholder-employee's salary (up to $3,000) is subject to a 3 per cent payroll tax for unemployment insurance, which may, however, be reduced by merit-rating. Consequently, the social security taxes of the stockholder employee may amount to $198 annually (3 per cent of $3,600, plus 3 per cent of $3,000).

Since a partner is not an employee of a partnership for social security tax purposes, he pays no tax for unemployment insurance and his tax for an old age benefits is limited to 2½ per cent of his income up to $3,600 or $81 a year.

Perhaps the most significant consideration with respect to social security taxes in choosing a form of business organization is that since a partner is not an employee of the partnership, a business conducted as a partnership, which has only seven employees besides the working partners, will not be subject to a tax for unemployment insurance, which is only imposed where there are eight or more employees.

However, the fact that a stockholder may be an employee of a corporation, while a partner cannot, at least for tax purposes, be an employee of the partnership, makes it possible to set up a qualified profit sharing, stock bonus, or pension plan in connection with a corporation by which the owners of the corporate business can defer income until after their retirement, which is not feasible in connection with the partners in a partnership.[25]

Although it may be possible to operate a business as a corporation as economically, or even more economically,[26] from a tax point of view, as a partnership or a sole proprietorship, it is clear that this depends upon adventitious circumstances of the particular situation. The law itself does very little to equalize the tax burdens of incorporated and unincorporated businesses. If there is any parity, it is only because taxpayers are shrewd and sophisticated enough to manipulate the law to reach this result. Here, as in so many other areas of federal tax law, one is constantly confronted with the distressing spectacle of a battle of wits, where the ultimate tax burden depends, not upon the taxpayer's economic situation, but upon his skill in circumventing the tax collector. This is an unhealthy situation which is directly attributable to the recognition of the corporation as a distinct taxable entity, and conforming the corporate tax to legal conventions rather than economic realities. If the present system of taxing close corporations is an inevitable administrative necessity, there is nothing to do except endure it. If, however, it is feasible to devise some more equitable system, the case for revision seems established.

THE CORPORATION AND TAX AVOIDANCE

The theoretical objections to the present system of taxing the income of close corporations are that the recognition of the corporation as a distinct taxable entity constitutes an unwarranted impediment to doing business in the corporate form and an active inducement to tax manipulation and avoidance. In order to bring these objections into sharper focus, it is convenient to postulate two distinct types of factual situations. In one, the assumption is that there is a group of lily white associates, who are seeking to conduct an enterprise for some legitimate business reason, which has no connection with tax avoidance, without incurring a tax penalty which would put them at a competitive disadvantage with unincorporated businesses. The other

On the other hand, if the business is conducted as a corporation and one or more of the stockholders (in addition to the seven non-stockholder employees) work for the corporation, it will be subject to the tax for unemployment insurance.

[25] To qualify for tax benefits such plans must be confined to employees. A stockholder-employee may be covered by such a plan, but a working partner, since he is not technically an employee of the partnership, may not.

[26] A minor advantage which the corporation enjoys over the unincorporated business is that sole proprietors and partners must pay their income taxes currently as the income is earned, while the corporation does not have to pay until after the close of the taxable year. Formerly a corporation could pay its tax in four quarterly installments in the year after the close of the taxable year, so the corporation could retain the money needed to meet the tax for a year longer than an individual. Under the 1950 Act the privilege of paying the corporate tax in four installments is being gradually withdrawn, so that after December 31, 1954, corporations must pay their taxes in two equal installments, one of which, in the case of a calendar year taxpayer, will be due on March 15 and the other on June 15. INT. REV. CODE §56(b)(2), as amended by §205, 1950 Act.

situation assumes a black hearted rascal, who resorts to a corporation, not because he has any independent business reason for conducting his affairs in the corporate form, but solely to dodge his fair share of the tax burden.

The dichotomy is, of course, entirely unreal. It is offered simply as a convenient hypothesis for analyzing the principal objections to the corporate tax. Doubtless there are cases where a corporation is resorted to without any thought of tax avoidance as a logical way to organize a business, and any subsequent tax maneuvering is purely defensive to avoid the unfair burden of a double tax. At the other extreme, there are situations where a taxpayer uses a corporation, although it is an unnatural and awkward way of arranging his affairs, purely from tax avoidance motives. Most cases, however, fall somewhere between the extremes, and the corporate form is adopted both because it is a convenient way of doing business and because it offers certain tax advantages.

The classification of the operational characteristics of the corporate tax under the headings of the use of the corporation as a method of carrying on a business and the use of the corporation as a medium for tax avoidance is even more arbitrary than the factual assumptions that the corporation is resorted to exclusively for one or the other purpose. Thus, for example, although paying out corporate profits in the form of reasonable salaries in order to eliminate the corporate tax might fairly be characterized as a defensive maneuver designed to neutralize the unfair burden which the corporate tax imposes on incorporated partnerships and proprietorships, resort to the corporate form in order to get a lower rate of tax upon the profits retained in the business in the case of an expanding enterprise clearly envisages a tax advantage denied unincorporated businesses and savors of tax avoidance. The classification of the operational characteristics of the corporate tax, like the factual assumptions which furnish the basis for the classification, is a matter of convenience rather than strict analytical affinity. The aspects of the tax discussed in connection with the use of the corporation as a method of carrying on business appear in that context simply because it is a convenient place to consider them. The same thing is true of the aspects of the tax considered in connection with the use of the corporation as a method of tax avoidance. Some of the quirks of the corporate tax operate to ease the discrimination between incorporated and unincorporated businesses, while others are calculated to enable a taxpayer to escape his fair share of the tax burden. However, the classification of these characteristics in this paper is purely a matter of descriptive convenience. It involves neither logical coherence, nor tacit moral judgment.

It is difficult to appraise the precise amount of tax avoidance attributable to the current system of taxing the income from close corporations, because there is no solid statistical data to determine how the tax actually operates on a practical level. The recognition of the corporation as an independent taxable entity constitutes a wide open invitation to tax manipulation, because it affords an opportunity to try out practically every type of tax avoidance. Congress has, however, been more at-

tentive to the loopholes in the corporate tax than it has to the possibilities of discrimination against incorporated business due to the double tax, and the courts have struggled valiantly to plug up any loopholes which Congress may have missed, even to the point of plugging up loopholes where no loophole existed.[27] The over-all pattern of the corporate tax presents a curiously futile competition between a basically unsound tax and a frenzied patchwork of provisions designed to cure the ills created by an initially erroneous approach. By recognizing the close corporation as an independent taxable entity, Congress gave impetus to a vast number of tax dodges, which it has been trying to outlaw ever since. Upon the violent assumption that the safeguards against tax avoidance which have been written into the corporation tax are actually effective, it still seems that it would have been simpler to adopt a tax predicated upon economic realities which would not have lent itself to tax avoidance, instead of starting with a postulate which is a positive inducement to tax avoidance and then trying to suppress these maneuvers.

A. Incorporated Pocketbooks

Perhaps, the most obvious type of tax avoidance fostered by the recognition of the corporation as an independent taxable entity is the so called" incorporated pocketbook." When corporate rates are low in comparison with individual rates, a wealthy individual may incorporate his estate to realize his income in the form of corporate income taxable at the lower corporate rates. This is known as an incorporated pocketbook. For example, the law provides that dividends received by a corporation from a domestic corporation[28] and certain foreign corporations, which are subject to the federal income tax,[29] may be credited against net income of the stockholder corporation to the extent of 85 per cent of the dividends, to compensate for the corporate tax to which the income represented by the dividends was subjected in the hands of the distributing corporation. Moreover, such dividends are not subject to the excess profits tax.[30] This means that only 15 per cent of an intercorporate dividend is subject to the corporate income tax, or to restate the matter from another angle, dividends received by a corporation are only taxed at 15 per cent of the regular corporate rates. Consequently, if an individual could put his stock holdings in an incorporated pocketbook, whose net income did not exceed $25,000, the dividends received by the incorporated pocketbook would only be taxed at 15 per cent of 30 per cent (the rate for corporations whose income does not exceed $25,000) or 4.5 per cent.

As early as the 1913 Act, which was the first of the modern federal income tax acts adopted after the ratification of the Sixteenth Amendment, Congress recognized the incorporated pocketbook as an inevitable corollary of the identification of the corporation as an independent taxable entity, and attempted to set up appropriate safeguards. In order to work an incorporated pocketbook successfully, it is necessary

[27] Commissioner v. Court Holding Co., 324 U. S. 331 (1945). See note 20 *supra*.
[28] INT. REV. CODE §26(b)(1).
[29] *Id.* §26(b)(3).
[30] *Id.* §433(a)(1)(A).

not only to divert income to a corporation, but to retain the income in the corporation in order to avoid a tax upon the individual stockholders. Congress seized upon the accumulation of the corporate earnings as the vulnerable spot at which to strike incorporated pocketbooks by imposing a penalty tax upon a corporation formed or availed of for the purpose of avoiding individual surtaxes upon its stockholders by accumulating earnings beyond the reasonable needs of the corporate business. At first the tax took the form of taxing the shareholders upon their distributive shares of the corporate income.[31] The 1921 Act changed the tax to an additional tax upon the corporate income,[32] and in this form it persists to the present day under the peculiarly non-committal title of the Section 102 surtax.[33]

As a practical matter the Section 102 surtax has done little to check the rise of incorporated pocketbooks. The weakness of the tax lies in the fact that it is a penalty tax whose application is subject to the difficulties of proving that a corporation has accumulated surplus beyond the *reasonable* needs of the corporate business for the *purpose* of avoiding individual surtaxes upon its stockholders. Incorporated pocketbooks continued to flourish under the Section 102 surtax until they reached the dimensions of a national scandal. Hollywood, which frequently takes the lead in tax fashions, produced some of the most bizarre examples of incorporated pocketbooks. It became almost standard practice for a cinema star to form a corporation to which he would sell the right to his services for a modest amount, in order that the corporation could in turn sell the star's services to the producer and convert his salary into corporate income taxable at the lower corporate rates.

A good many incorporated pocketbooks might have been put out of business by the old fashioned device of disregarding the corporate entity. When a motion picture actor formed a corporation to sell his services, it would have required no great degree of judicial perspicacity to penetrate the corporate disguise and tax the compensation for the star's services directly to the star. If a lawyer cannot divert part of his fees to his wife by an agreement that any income earned during their marriage shall belong to them equally,[34] it is difficult to see why a cinema actor should be allowed to divert his income to a corporation through the crude fiction of selling the right to his services to a corporation and having the corporation sell his services

[31] Act of Oct. 3, 1913, c. 16, 38 STAT. 114, 166-167; Revenue Act of 1918, c. 18, 40 STAT. 1057, 1072.

[32] Revenue Act of 1921, c. 136, 42 STAT. 227, 247-248.

[33] The rates of the tax are 27½ per cent of the first $100,000 of the corporation's undistributed net income, and 38½ per cent of the balance in excess of that amount. Although the tax is in addition to the other taxes on corporate income, it is not necessarily a deterrent to accumulating profits in a corporation to avoid individual surtaxes. It may be cheaper for a stockholder in a very high bracket to leave earnings in the corporation and pay the penalty tax, than to distribute them as dividends and incur the individual tax.

[34] Lucus v. Earl, 281 U. S. 111 (1930). See also Jones v. Page, 102 F. 2d 144 (5th Cir. 1939), *cert. denied,* 308 U. S. 562 (1939), where a taxpayer sold the right to his services to his father, who in turn sold them to a motion picture producer, and the court held that the amount paid by the producer was taxable to the taxpayer, who performed the services, declaring (p. 145): "The conclusion is inescapable that he used his father simply as a conduit in an attempt to reduce or avoid taxes that would be otherwise assessable against compensation derived from his own personal services."

to the producer. The courts were, perhaps, tending in this direction[35] when Congress stepped in to supply its own solution through the surtax on personal holding companies.[36]

The surtax on personal holding companies, which was adopted as a more effective deterrent to incorporated pocketbooks than the Section 102 surtax, is a complicated piece of legislation. The basic idea is, however, that the type of corporation which appears most likely to be used as an incorporated pocketbook is called a personal holding company and a prohibitive surtax[37] (in addition to the regular corporate tax[38]) is imposed upon such organizations. The personal holding company surtax is effective in the narrow area in which it operates, like the corporation formed by the Hollywood actor. The rates of the tax are sufficiently stringent to discourage effectively personal holding companies and the tax applies automatically to corporations falling within this category, without proof that they are being used to accumulate unreasonably surplus for the purpose of avoiding individual surtaxes. The weakness of the tax, however, lies in its very definiteness and rigidity. In order to qualify as a personal holding company, a corporation must meet certain detailed statutory specifications with regard to stock ownership and the character of its income.[39] By diversifying the ownership of the corporation or the character of its income, it is relatively easy to sidestep the tax. As a matter of fact, the personal holding company surtax is more of a trap for the unwary individual who unconsciously drifts into a personal holding company situation, than it is a snare for the sophisticated tax avoider who is careful to guard against it.

An incorporated pocketbook, which escapes the personal holding company surtax, may still encounter the Section 102 surtax. Like the personal holding company surtax, however, the Section 102 surtax is less effective as a snare for the shrewd tax avoider, who always has a list of unassailable alibis for accumulating corporate surplus at his finger tips, than it is as a threat dangling over the head of the innocent corporation, which lives in constant terror of a Section 102 penalty whenever it fails to distribute the last penny of its profits.[40]

Probably the finest flowering of the incorporated pocketbook was the foreign personal holding company. A wealthy taxpayer would organize a corporation in

[35] *Cf.* Commissioner v. Laughton, 113 F. 2d 103 (9th Cir. 1940).

[36] INT. REV. CODE §§500-506. The personal holding company surtax first made its appearance in the 1934 Act. In 1937 the tax was rewritten in substantially its present form to catch many of the more blatant devices like the Hollywood corporation which escaped the earlier law.

[37] The rates of the tax are 75 per cent of the first $2,000 of the corporation's undistributed net income, and 85 per cent of the balance.

[38] A personal holding company is not subject, however, to the Section 102 surtax.

[39] A corporation is not classified as a personal holding company unless 80 per cent or more (in some cases this is reduced to 70 per cent) of its gross income is personal holding company income, and more than 50 per cent of its outstanding stock is owned directly or indirectly by not more than five individuals. Personal holding company income includes, with certain exceptions, dividends, annuities, interest, royalties, gains from stock, security and commodity transactions, rents, and income from trusts and estates, personal service contracts, and use of property by a shareholder. Indirect ownership of stock includes ownership of stock owned by a member of an individual's family, or a corporation, partnership, or trust in which he owns an interest.

[40] See note 7 *supra*.

Bermuda, or some foreign country where income taxes were low or non-existent, and accumulate his income in the corporation in order to remove it from the taxable jurisdiction of the United States. Congress struck at foreign personal holding companies with special legislation,[41] the most interesting aspect of which is that it disregards the corporate entity and taxes United States shareholders directly upon their distributive shares of the corporation's income.

The Section 102 surtax along with the surtaxes upon domestic and foreign personal holding companies have certainly made the life of the incorporated pocketbook more exciting and evoked new heights of skillful and sophisticated tax planning. It is doubtful whether they have put an end to the device entirely. In the absence of actual statistical data, it is difficult to estimate the gap between theory and practice. There is little reason to doubt the existence of a substantial gap, however, or that refined versions of the incorporated pocketbook are operating successfully today.

B. Splitting Income

A basic principle for avoiding a progressive tax is to divide a large income taxable in the higher brackets into smaller incomes taxable in lower brackets. The recognition of the corporation as an independent taxable entity is especially well adapted to this process. The simplest way to split up an income taxable in a high bracket into smaller incomes taxable in lower brackets is to make a complete and irrevocable gift of income producing property. This has, however, the practical disadvantage of requiring the taxpayer to sacrifice income and the property which produces the income. One of the most appealing ways, therefore, to split income, is to transfer income producing property to a corporation controlled by the taxpayer, since this offers the opportunity of diverting income to a distinct taxable entity, without losing the substantial ownership of the income, or the property which produces it.

There are various ways of dividing income through the medium of a corporation. One method, which was mentioned earlier, is to transfer a business to a corporation and distribute part of the corporate earnings to the stockholders in the form of salaries, interest or rents, so that part of the income is taxed to the stockholders, while the balance of the corporate profits are retained in the corporate treasury and taxed to the corporation.

The tax upon the income retained by the corporation may be further reduced by splitting up the corporate business among several corporations so as to avoid the excess profits tax and take advantage of the lower brackets of the corporate tax. The desirable level at which to hold corporate income is $25,000, since the corporate surtax starts at this point and every corporation is allowed a minimum excess profits tax credit of that amount.[42] Where the income of a business is divided among

[41] INT. REV. CODE §§331-340.

[42] The tax on the first $25,000 of corporate income is 30 per cent. Any amount in excess of $25,000 is taxed at 52 per cent. If the corporation is subject to the excess profits tax its income over $25,000 may be taxed at 82 per cent.

several corporations (or for that matter between a corporation and a partnership or a sole proprietorship), there is an ever present danger that the division will be disallowed for tax purposes and the entire income from the enterprise taxed to a single entity.[43] Usually, however, the division of corporate income will stand up for tax purposes, if the division is a natural division of the business, or there is some independent business reason, apart from tax avoidance, for the division.[44]

A corporation may afford a convenient medium for splitting up an income from a business through gifts of stock in the corporation. With the recent relaxation of the rules for taxing the income from family partnerships[45] and permission to husbands and wives to split their incomes,[46] there is less pressure for resorting to a corporation to divide an income among a family group. In the past, however, one of the ways of dividing an income from a business among the members of a family was to incorporate the business and distribute the stock in the corporation among the family group. So far no doctrine of a family corporation, analogous to the family partnership doctrine, has developed to tax the income from the business to the original proprietor,[47] although the division of the income may be ignored, if the donees do not get a real stock ownership in the corporation and the whole arrangement is a patent sham.[48]

C. Acquisitions of Deficit Corporations

During World War II the practice grew up of a profitable corporation purchasing a deficit or "shell" corporation, in order to take advantage of an excess profits tax credit, a net operating loss carry-over, or a high basis for depreciable assets

[43] INT. REV. CODE §45 authorizes the Commissioner in the case of "two or more organizations, trades or businesses . . . owned or controlled directly or indirectly by the same interests . . . to distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organization, trades, or businesses." Frequently, when the Commissioner seeks to re-allocate the income of several entities owned by the same interests, he invokes the common law doctrine of disregarding the corporate entity in addition to Section 45. Although in a given case the two approaches may come out at the same place, they appear to be theoretically distinct, since Section 45 proceeds upon the theory of re-allocating income and deductions between existing entities, while disregard of the corporate entity is premised upon the postulate that the corporation has no realty but is a sham.

In an effort to prevent "spin-offs, split-ups, and split-offs" (see Holzman, *Spin-Offs, Split-Ups, and Split-Offs*, 5 NAT. TAX JOUR. 277 (1952)) solely for tax purposes, the 1951 Act provided that where a corporation transfers all or a part of its property to a newly created or previously inactive corporation, which after the transfer is controlled by the transferor corporation or its stockholders, the transferee corporation loses the $25,000 surtax exemption and minimum excess profits tax credit, unless it proves that obtaining the exception and credit was not a major purpose of the transfer. INT. REV. CODE §15(c), added by §12(f), 1951 Act. The new provision is limited to transfers after January 1, 1951, and is to remain in force only as long as the excess profits tax is in effect. Its probable efficacy seems questionable in view of the fact that it does not apply if it can be shown that tax avoidance was not a "major purpose" of the transfer.

[44] See Landman, *Multiplying Business Corporations and Acquiring Tax Losses*, 8 TAX L. REV. 81 (1952).

[45] INT. REV. CODE §191, added by §340(b), 1951 Act.

[46] *Id.* §12(d), added by §301, 1948 Act.

[47] But see Alexandre, *The Corporate Counterpart of the Family Partnership*, 2 TAX L. REV. 493 (1947).

[48] Overton v. Commissioner, 6 T. C. 304 (1946).

of the deficit corporation. In an effort to plug this loophole Congress in 1943 added Section 129 to the Code, which provides that where a deficit corporation is purchased for the principal purpose of avoiding federal income or excess profits taxes by "securing the benefit of a deduction, credit, or other allowance" which the purchaser would not otherwise enjoy "then such deduction, credit or other allowance shall not be allowed." Unfortunately, the provision designed to plug the loophole soon developed its own loopholes and a lively market still exists for deficit corporations. Section 129 does not apply unless the principal purpose of the acquisition of the shell corporation was to take advantage of its credits or exemptions. If the loss corporation was acquired for some independent business reason, other than tax avoidance, Section 129 has no application. It seems fairly inferable from the fact that the Commissioner has so far failed to invoke Section 129 successfully in any case, that it is not very difficult to prove that the motive for acquiring a shell corporation was not tax avoidance.[49] Section 129 may have a more serious defect. In several cases the Tax Court has intimated that Section 129 has no application where a deficit corporation is acquired and a profitable business is conveyed to the loss corporation.[50] The basis of the argument is that in this case the shell corporation is entitled to apply its own credits and deductions against the income from the profitable business, because this is not a credit or deduction which it would not "otherwise enjoy." In other words apparently a profitable business cannot use the deductions and credits of a loss corporation. However, if a deficit corporation is acquired by a profitable business and the profitable business is transferred to the loss corporation, which continues to operate the business, there is no objection to using its credits and deductions. Obviously, if this line of reasoning is sound it robs Section 129 of any real significance. The "shell" corporation continues to operate as a "shell game" without any serious legal impediments.

D. Minimizing Taxes in Connection with the Withdrawal of Corporate Profits

Most schemes for avoiding taxes by diverting income to a corporation are dependent for their ultimate success upon the ability of the shareholders to withdraw the earnings which have accumulated in the corporation without incurring the individual tax at the time of withdrawal. The crudest way to do this, and the way which has the least chance of success if it is detected, is to disguise the withdrawal as a loan or some other form of tax-free advancement from the corporation to the stockholder. The tax law is not choosy about the form of a dividend. Any distribution of taxable corporate profits will be taxed as a dividend. If the disguise of a loan can be penetrated, and beneath judicial scrutiny it usually can,[51] the so-called loan will be taxed as a dividend, with the further unpleasant possibility of a fraud penalty.

[49] Holzman, *Who Wants a Tax Loss?*, 20 THE CONTROLLER 463 (1952); Landman, *Multiplying Business Corporations and Acquiring Tax Losses*, *supra* note 44.

[50] A. B. & Container Corp. v. Commissioner, 14 T. C. 842 (1950); Commodores Point Terminal Corp. v. Commissioner, 11 T. C. 411 (1948); Alprosa Watch Corp. v. Commissioner, 11 T. C. 240 (1948).

[51] See, for example, Regensburg v. Commissioner, 144 F.2d 41 (2d Cir. 1944).

The most satisfactory way to withdraw profits from a close corporation is to wait until the principal stockholder dies and liquidate the corporation. Upon the liquidation of a corporation, the redemption of the stockholders' stock is treated as a purchase of the stock by the corporation and taxable gain or loss is limited to the difference between the amount paid by the corporation to redeem the stock and the basis of the stock to the stockholders.[52] When a stockholder dies his stock takes as its basis the fair market value of the stock at the date of his death, or one year after his death, if the optional valuation date is used for estate tax purposes.[53] Since this will presumably be equal to, or greater than, the liquidating value of the stock, his share of the corporate profits can be withdrawn tax-free at his death by having the corporation liquidate and redeem his stock.

If the stockholders in a close corporation are not considerate enough to die in order to facilitate the withdrawal of the corporate profits without incurring the individual tax, the most economical way to get the profits out of the corporation is to liquidate so that the stockholders' gains will be taxed as long-term capital gains. Upon the complete liquidation of the corporation, since the redemption of the corporate stock is treated as a sale of the stock to the corporation, the stockholder will only be taxed upon the difference between what he receives and his basis for the stock. Ordinarily, moreover, the stock will represent a capital asset held by the stockholder for more than six months, so any gain will be a long-term capital gain subject to the favorable tax treatment accorded such profits.

Where a corporation is completely liquidated there is usually no difficulty about treating the stockholders' gains as long-term capital gains. In the case of a partial liquidation, however, where only part of the stock is redeemed, the income tax draws a difficult distinction between a genuine liquidation, which is treated as a sale or exchange of the stockholder's stock to the corporation, and a distribution of corporate profits disguised as a partial liquidation, which is taxed as an ordinary dividend.[54] In the case of a close corporation particularly, a partial liquidation is almost always exposed to the hazard of being taxed as an ordinary dividend under Section 115(g).[55]

One of the alleged advantages of "thin incorporation" is that corporate earnings

[52] INT. REV. CODE §115(c).

[53] *Id.* §113(a)(5).

[54] *Id.* §115(g)(1).

[55] See Bittker and Redlich, *Corporate Liquidations and the Income Tax*, 5 TAX L. REV. 437, at 455-480 (1950); Murphy, *Partial Liquidations and the New Look*, 5 TAX L. REV. 73 (1949). In Commissioner v. Trustees Common Stock John Wanamaker Philadelphia, 178 F. 2d 10 (3d Cir. 1949), it was held that the purchase of a parent corporation's stock by a subsidiary could not be taxed as an ordinary dividend under Section 115(g)(1), because that Section applies only if a corporation cancels or redeems its own stock. The 1950 Act provided that for taxable years beginning after August 31, 1950, the purchase of the stock by the subsidiary will be treated as though the subsidiary distributed the money used to purchase the stock to the parent, and the parent used the money to redeem its stock, and will be taxed as an ordinary dividend if the redemption of the stock by the parent would be an ordinary dividend. INT. REV. CODE §115(g)(2), added by §208(e), 1950 Act. Apparently, however, there is nothing to prevent one corporation from buying stock of another corporation which is controlled by the same interests.

can be distributed to redeem bonds or pay off debts without subjecting the creditor-stockholder to any tax if the distribution does not exceed the amount he has loaned to the corporation. It is assumed that Section 115(g) presents no problem in this connection because that Section refers to a redemption of stock, not bonds. If, however, the incorporation is so thin that a court will regard the borrowed capital as in substance equity capital, it would seem that the redemption of the corporation's bonded indebtedness might result in a taxable dividend under Section 115(g).[56]

E. Collapsible Corporations

Where the rate differential between the corporate and individual taxes permits, one way of saving taxes by means of a corporation is to incorporate an enterprise and allow the income from the undertaking to be taxed in the first instance to the corporation, and then to liquidate the corporation and withdraw the profits in the form of long-term capital gains. The collapsible corporation, another Hollywood super-colossal production, refined on this plan by a stroke of sheer genius which eliminated the corporate tax by liquidating the corporation before any income was realized. Like most great ideas the scheme behind the collapsible corporation is basically simple. It is best illustrated by a typical example. Suppose that *A*, *B*, and *C* decide to produce a motion picture from which they reasonably anticipate a profit of $3,000,000. If they form a partnership and net $3,000,000 from the picture in a single year, they will each be taxed upon ordinary income of $1,000,000, upon which, if they are married men whose wives have no independent income, the tax will be in the neighborhood of $873,000, so the total tax will be $2,619,000. Consequently, the associates organize a corporation to produce the picture. After the picture is completed and the contracts have been made for its release, but before the corporation has realized any income from them, the associates liquidate the corporation and distribute the contracts to themselves in exchange for their stock. The corporation realizes no income. The stockholders incur a long-term capital gain to the extent of the difference between the fair market value of the contracts for the exhibition of the picture and the basis of their stock, upon which the maximum tax will be 26 per cent. Assuming that they invested $1,000,000 in the corporation and that the contracts have a fair market value of $4,000,000, they will realize a long-term capital gain of $3,000,000 upon which the maximum tax will be 26 per cent, or $780,000. If they subsequently realize no more from the exhibition of the picture than the fair market value assigned to the contracts, they will have no further income, because the amortization of the contracts will offset the receipts from the contracts.

This is the collapsible corporation which originated in the motion picture industry and had spread to other fields of endeavor, such as the building industry, before the 1950 Act caught up with it by providing that any gain upon the liquidation of the corporation shall be taxed to the stockholders as ordinary income.[57] Under the

[56] See Stein v. Commissioner, 46 B.T.A. 135 (1942), *supra* note 13.

[57] INT. REV. CODE §117(m), added by §212, 1950 Act. The tax on collapsible corporations only

present law, therefore, the associates in the hypothetical case would incur the same tax regardless of whether they operated as a collapsible corporation or partnership. It is perhaps too early to say whether the new provisions for taxing collapsible corporations will actually put an end to this interesting device.

The 1950 Act, which was obviously drafted with a view to the use of the collapsible corporation in the motion picture and construction industries, only applied to corporations engaged in the manufacture, construction or production of property. It overlooked the situation where the same device was resorted to to convert profits from the sale of stock in trade into capital gain. For example, suppose that *A* owns a large quantity of whiskey which he holds primarily for sale. *B* wishes to purchase the whiskey, but if *A* sells it to him directly the gain from the sale will be taxed as ordinary income. Consequently, *A* organizes a corporation to which he makes a tax-free transfer of the whiskey under Section 112(b) (5) in return for all of the corporation's stock. *A* sells the stock in the corporation to *B*, realizing a capital gain on the sale, and *B* liquidates the corporation and gets the whiskey without incurring any further tax.[58] Under the 1951 Act,[59] the tax on collapsible corporations was extended to this situation by taxing *A*'s profit from the sale of the stock in the corporation as ordinary income. It is questionable, however, whether the tax on collapsible corporations is really effective to ban this device. For example, the tax only applies to a stockholder who owns directly or indirectly more than 10 per cent of the stock of the collapsible corporation,[60] which suggests that all that is needed to escape the tax is a bigger and better collapsible corporation with more diversified ownership. Moreover, the tax does not apply unless more than 70 per cent of the gain realized from the sale of the stock is attributable to the property manufactured, constructed, produced or purchased by the corporation, and the gain is realized less than three years after the manufacture, construction, production or purchase, which obviously opens up some interesting avenues for speculation. Since the sale of an interest in a partnership is treated as the sale of a capital asset,[61] it has been suggested that the result of a collapsible corporation might be obtained by a collapsible partnership. That is, the associates in the hypothetical case where the object of the venture was to produce a picture might, for example, form a partnership and make the picture and sell their interests in the partnership before any income was realized from the picture in order to convert their profits into long-term capital gains.

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applies to years ending after 1949 and only to gains realized after December 31, 1949. It has been suggested that it would be possible to tax the gain from a collapsible corporation as ordinary income without any express legislative authorization to that effect. See Bittker and Redlich, *supra* note 55, at 439-448. But see Herbert v. Riddell, 103 F. Supp. 369 (S. D. Calif. 1952) (sustaining the validity of a pre-1950 collapsible corporation).

[58] Commissioner v. Gracey, 159 F. 2d 324 (5th Cir. 1947).

[59] INT. REV. CODE §117(m), as amended by §326(a), 1951 Act.

[60] In this connection stock ownership is determined by the same rules which govern stock ownership in a personal holding company (INT. REV. CODE §503(a)(1), (2), (3), (5), and (6)), except that for the purpose of a collapsible corporation an individual's family also includes spouses of his brothers and sisters and spouses of his lineal descendants. INT. REV. CODE §117(m)(3).

[61] G.C.M. 26379, 1950 I. C. B. 58; Swiren v. Commissioner, 183 F. 2d 656 (7th Cir. 1950).

F. Fictitious Gains and Losses

A loss cannot be deducted under the income tax until it has been sustained or realized. In connection with the sale or exchange of property, this means that the taxpayer must part irrevocably with his interest in depreciated property before he can take a tax loss. Taxpayers have persistently attempted to circumvent this rule and deduct things like downward fluctuations in the market price of stocks or securities by more or less fictitious sales. One technique which has been tried, without any marked degree of success, has been to sell property to a corporation controlled by the seller. Apart from express legislative mandate the courts have refused to recognize such losses by disregarding the corporate entity and regarding the transaction as a sale by the taxpayer to himself.[62] The statute now explicitly disallows losses upon sales or exchanges between a taxpayer and a controlled corporation, as well as losses connected with sales and exchanges between members of the same family and certain parties to trusts.[63]

The statutory disallowance of losses on sales between a stockholder and a controlled corporation does not extend to gains. Consequently, the practice grew up of selling depreciable property, which had a low tax basis, to a controlled corporation at a price substantially greater than the basis of the property. The tax advantage was that the taxpayer would incur a gain which would be taxed as a long-term capital gain under Section 117(j) of the Code, but the corporation would acquire a stepped-up basis for the property against which it could take a 100 per cent deduction for depreciation. Recent legislation seeks to curb this practice by taxing the gains on such sales as ordinary income.[64]

Conclusion

The object of this paper has been to present an unbiased critique of the current method of taxing the income from close corporations, rather than an exhaustive blueprint for tax avoidance. Consideration of the further possibilities of manipulating the corporate tax, which doubtless exist in particular situations, would merely serve to emphasize the inequities of the present system without adding materially to the aggregate discussion. There appears to be ample evidence of the inherent unsoundness of the current method of taxing the income of close corporations, and that this results primarily from the fact that tax is premised upon a legal fiction rather than economic realities.

The identification of the close corporation as an independent taxable entity interposes an unwarranted impediment to the free choice of a form of business organization. It is true that by careful tax management corporate taxes may be kept at a minimum, and, in a given situation, it may even be possible to operate more eco-

[62] Higgins v. Smith, 308 U. S. 473 (1940); but see Commissioner v. W. F. Trimble & Sons Co., 98 F. 2d 853 (3d Cir. 1938); General Industries Corporation v. Commissioner, 35 B.T.A. 615 (1937) (A); Helvering v. Johnson, 104 F. 2d 140 (8th Cir. 1939), *aff'd by an equally divided court*, 308 U. S. 523 (1939).

[63] INT. REV. CODE §24(b).

[64] *Id.* §117(o), added by §328, 1951 Act. See note 19 *supra*.

nomically as a corporation than as a partnership or sole proprietorship. The relative tax burdens of incorporated and unincorporated partnerships and proprietorships turn, however, upon the shrewdness of the taxpayer and his ability to outwit the tax collector, rather than the economic situation of the particular enterprise. The conduct of a business under the current system of taxing the income from close corporations becomes a matter where sound business practice must be subordinated to tax considerations.

The recognition of the corporation as a distinct taxable entity is a forceful inducement to tax avoidance. It is questionable just how effective the elaborate statutory paraphernalia for suppressing the tax maneuvers stimulated by the identification of the corporation as an independent taxable entity actually are. Upon the assumption, which is clearly unwarranted, that the statute provides perfect theoretical safeguards to prevent tax avoidance by the manipulation of the corporate tax, it is still uncertain how effectively these safeguards operate upon the practical level. There are a good many practices, like the deduction of losses on sales to controlled corporations or splitting up the income of a business by multiplying corporate entities, without any independent business reason for the division, which are constantly indulged in, because of ignorance or intent, and completely escape the eye of the tax gatherer. It requires incredible naïvete to believe that taxpayers are actually aware of the abstruse safeguards against the misuse of the corporate device to avoid taxes, or that they observe them, if they are.

Since the objections to the present form of taxing the income from close corporations stem from the recognition of the corporation as an independent taxable entity, the obvious solution appears to be to disregard the corporate entity for tax purposes, and to tax the stockholders of a close corporation directly upon their distributive shares of the corporate income in the same way in which the income of a partnership is taxed to the partners. If a close corporation is simply a partnership or a sole proprietorship with a thin and taxwise immaterial corporate veneer, there is no reason for ignoring its true character for tax purposes.

The most sensible argument against ignoring the corporate entity and taxing the income of a close corporation directly to the stockholders is that this would involve certain administrative problems. It is difficult to believe, however, that the administrative difficulties would approximate the problems which are encountered in the administration of the present system of taxing corporate income and the constant controversies over where tax avoidance leaves off and tax evasion sets in. It is easy to exaggerate the administrative difficulties connected with taxing the shareholders of a close corporation upon their distributive shares of the corporate income by confusing the problem with the taxation of the income of widely held, publicly owned corporations. The attempt to determine the stockholders' shares of the income of a widely held public corporation, whose stock is constantly traded in, might well present an administrative nightmare. This problem does not exist, however, in the case of a close corporation, where stock ownership is as static as the ownership of a part-

nership. For all practical purposes, save the accident of incorporation, a close corporation is a partnership. It would not be difficult to tax it as such.

The most difficult problem in connection with taxing the income of a close corporation like the income of a partnership, is to draw the line between close corporations, which are to be taxed in this way, and other corporations subject to the ordinary corporate tax. This should not, however, prove an insuperable obstacle. It would probably be unwise to draw the line at any arbitrary capitalization or number of stockholders. However, it would seem possible to make a distinction between those corporations whose stock is available to the public through a recognized exchange, or in over the counter markets, and those whose stock does not appear in any recognized market, or cannot be purchased without the consent of the corporate associates.[65] In other words, following the partnership analogy, those corporations whose membership is as stable and selective as that of a partnership would be taxed as partnerships.

One danger in taxing a close corporation like a partnership is that this might be unfair to a minority stockholder, where those in control of the corporation refuse to distribute any dividends, since he would be obliged to pay a tax upon income which he could not reach, or even use to pay the tax. This again, however, does not seem to be an insuperable obstacle. It would be simple enough to empower the Commissioner to collect the tax due from the minority stockholder from the corporation, when he filed an appropriate declaration of his predicament.

Among the arguments which would undoubtedly be made against taxing the income of close corporations like the income of a parntership are that this would not allow a corporation to retain earnings needed for expansion, and that it would be unconstitutional. There appears to be no substance in the argument that a close corporation should be allowed to retain earnings without exposing them to a tax in the hands of the stockholders. Partners are taxed upon the part of the partnership income which is plowed back into the partnership business. If there is a practical parallel between a partnership and a close corporation, there is no reason why the stockholders of the close corporation should be treated differently.

The constitutional objection is scarcely more meritorious. Upon the assumption that there is no substantial difference between a close corporation and a partnership or a sole proprietorship, it would be fantastic to find that taxing the income of a close corporation in the same way in which the income of a partnership or proprietorship is taxed is so arbitrary or discriminatory that it violates due process. Apart from an attack upon the proposed plan for taxing the income from close corporations upon the score of the due process, the only other possible constitutional objection to

[65] I am indebted for this thought to my colleague Professor Elvin R. Latty, although I must take the responsibility for the vague and indefinite language in which I have attempted to pass it on. The term "over-the-counter markets" is not to be interpreted, as it has sometimes been with respect to the application of the Securities Exchange Act, to include all transactions not on an organized stock exchange, but as limited to transactions in the securities markets through professional channels. See Latty, *The Aggrieved Buyer or Seller or Holder of Shares in a Close Corporation Under the S.E.C. Statutes* (*supra*, pp. 505-534).

the tax appears to be the shopworn argument that stockholders cannot be taxed upon their undistributed shares of corporate income, because they "realize" no income until the corporate profits are distributed to them. It is true that in *Eisner v. Macomber*[66] the Supreme Court refused to sustain the constitutionality of a tax upon stock dividends upon the theory that the tax was really a tax upon the stockholders' shares in the undivided profits of the corporation. The Court said that a tax upon the stockholders' shares of the undistributed income of the corporation would be an invalid direct and unapportioned tax upon capital, rather than a tolerated tax upon income under the Sixteenth Amendment, and that *Collector v. Hubbard*,[67] which sustained such a tax in connection with the Civil War income tax acts, had been overruled by *Pollock v. Farmers' Loan and Trust Co.*[68] It is barely possible that there may be some constitutional objection to taxing the income of a widely held, publicly owned corporation to the stockholders of the corporation before it is distributed to them. It is extremely unlikely, however, that the present Court, which has hinted broadly of its conviction that *Eisner v. Macomber* was decided incorrectly,[69] would allow that case to stand in the way of a sane and rational system of taxing the income from close corporations.

If there is a constitutional objection to taxing the shareholders of a close corporation upon their distributive shares of the corporate income, the same result could easily be achieved by an undistributed profits tax, which the Supreme Court has held to be constitutional.[70] A genuine undistributed profits tax, as distinguished from the abortive effort which appeared in the 1936 Act,[71] except for accidental mechanical differences, does not differ in substance from taxing stockholders directly upon their distributive shares of corporate income. If the rate of tax is sufficiently stringent to compel corporations to distribute their earnings, the effect of the tax is not to tax the corporate income to the corporation, but to the shareholders to whom it must be distributed to avoid the tax.

[66] 252 U. S. 189 (1920).

[67] 12 Wall. 1 (U. S. 1870).

[68] 158 U. S. 601 (1895).

[69] Helvering v. Griffiths, 318 U. S. 371 (1943); see Lowndes, *The Taxation of Stock Dividends and Stock Rights*, 96 U. OF PA. L. REV. 147 (1947).

[70] Helvering v. Northwest Steel Rolling Mills, 311 U. S. 46 (1940).

[71] The president proposed a tax on undistributed profits which would compel corporations to distribute their earnings to their shareholders in whose hands the corporate earnings would be taxed, eliminating any corporate tax. Congress, however, watered down his proposal and enacted a measure whose rates were not sufficiently stringent to compel the distribution of corporate earnings, and which actually amounted to little more than an additional corporate income tax.

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